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Auditing Alternative Investments*

A Practical Guide for Investor Entities, Investee Fund Managers and Auditors

*connectedthinking

PricewaterhouseCoopers

Our perspective

We are pleased to provide you with this publication, entitled *Auditing Alternative Investments, A Practical Guide for Investor Entities, Investee Fund Managers and Auditors*, on an important topic that has been the focus of the various entities that invest in alternative investment funds, as well as to management of the investee funds.

As you are aware, many types of investors have been investing an increasing percentage of their investment portfolios in alternative investments and other non-traditional types of financial instruments. Recently, outside organizations, regulators and the accounting and auditing rule makers, such as the American Institute of Certified Public Accountants ("AICPA"), have begun to scrutinize the inherent risks associated with alternative investments, with a particular focus on the issues associated with due diligence, oversight and transparency.

In 2005, the AICPA issued an auditing interpretation (the "Interpretation") and, in 2006, a practice aid (the "AICPA Practice Aid"), which required auditors and management to respond quickly to new guidance with respect to the existence and valuation assertions associated with alternative investments. The main focus of the new guidance is as follows:

- With respect to existence, the question is: Do the investor entity's alternative investments exist at the financial statement date, and have the related transactions occurred during the period? While confirming the existence of assets that are held by third parties generally provides adequate audit evidence, the Interpretation and AICPA Practice Aid say that, by itself, a confirmation in the aggregate does not constitute adequate audit evidence.
- With respect to valuation, the question is: Are the alternative investments stated in the investor entity's financial statements at fair value? Confirming the value of the alternative investments from an investee fund manager provides one piece of evidence. Based on the guidance in the AICPA Practice Aid, additional audit evidence could be obtained.

More recently, on February 22, 2007, the President's Working Group on Financial Markets (the "PWG") publicly released its "Agreement among PWG and US Agency Principals on Principles and Guidelines regarding Private Pools of Capital" (the "PWG Principles and Guidelines"). These PWG Principles and Guidelines acknowledge the "significant benefits" that "private pools of capital," including hedge funds, bring to the financial markets and the challenges they pose. It encourages all relevant market participants (i.e., investors, creditors, counterparties, fund managers and regulators) to address them. It also acknowledges that "these pools can involve complex, illiquid or opaque investments and investment strategies that are not fully disclosed," and that such risks are "most appropriately borne by investors with the sophistication to identify, analyze and bear these risks." Interestingly, several of the principles and guidelines set forth by the PWG focus on transparency and due diligence, which are two of the main underlying themes addressed in the AICPA Practice Aid and discussed in this paper. For example, the PWG Principles and Guidelines state the following:

- Investors in private pools of capital should obtain accurate and timely historical and ongoing material information necessary to perform due diligence regarding the pool's strategies, terms, conditions and risk management, thereby enabling such investors to make informed investment decisions. (No. 4)
- Managers of private pools of capital should have information, valuation and, risk management systems that meet sound industry practices and enable them to provide accurate information to creditors, counterparties and investors with appropriate frequency, breadth, and detail. (No. 9)

The PWG Principles and Guidelines also acknowledge the balance that is necessary with respect to transparency. For example, No. 7.4 states that the "information that creditors and counterparties should seek to obtain from a private pool includes both quantitative and qualitative indicators of a private pool's net asset value, performance, market and credit risk exposure, and liquidity. The level of detail expected should respect the *legitimate interest of the private pool in protecting its proprietary trading strategies*" [emphasis added]. In No. 9.3, the PWG Principles and Guidelines further state that the "information provided by managers of private pools to their creditors, counterparties and investors should adhere to the sound practices articulated in industry guidelines. Managers of private pools of capital should provide information frequently enough and with sufficient detail that creditors, counterparties and investors stay informed of strategies, and the amount of risk being taken by the pool, and any material changes."

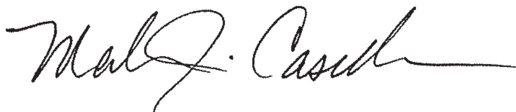
PricewaterhouseCoopers is uniquely positioned to provide leadership in the areas identified as concerns by regulators, the AICPA and others. We maintain a leadership position as auditors for both investee funds and investor entities – serving many of the largest and most complex alternative investment funds, and many of the most well-endowed higher education and not-for-profit organizations across the country. Our leadership position in both industries gives us a unique perspective and ability to converse with investors and investees, and to understand the implications and challenges for each. We have devoted considerable time and energy to studying these important issues, speaking about the new requirements and – most importantly – listening to the concerns of investors, investees and other industry participants. It is from this position of leadership that we have authored the enclosed publication.

The objective of this PricewaterhouseCoopers' publication is to summarize and highlight the AICPA's interpretative guidance on alternative investments. In addition, this publication is designed to address, from a practical perspective, the issues of most importance to officers, senior management, general partners, fund managers, board members and auditors of many diverse entities (e.g., hedge funds, private equity funds, fund-of-funds, colleges, universities and other highly endowed institutions). These issues include:

- What are the internal controls and leading practices that investor entities should consider implementing?
- How should transparency be viewed at the investor and investee level? Can transparency also be viewed broadly to encompass all forms of information and/or access requested by, or provided to, investors by management of investee funds?
- What is the importance of a management-developed risk assessment of the alternative investment portfolio? How does management view the risks compared to how the auditor views the risks?
- What are some practical suggestions for improving an investor entity's documentation of their internal controls?
- What lessons have we learned from the last two years of audits? How can we all be better prepared for the year-end audits of investor entities such as fund-of-funds, colleges, universities and other highly endowed institutions?

We are pleased to provide this publication to you and hope that it will serve as an informative and thought-provoking document that highlights existing guidance and provides a common message to both investors and investees as to how policies, procedures and controls might be enhanced.

Sincerely,



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Note: This paper is not intended to drive asset allocation decisions. It is meant to summarize and highlight key issues associated with the AICPA's interpretative guidance on alternative investments.

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1 | Executive summary

Recently, there has been considerable discussion regarding the audit requirements related to investor entities that invest in alternative investments. This discussion resulted from the issuance of the following guidance by the American Institute of Certified Public Accountants ("AICPA"):

- Interpretation No. 1 to AU332 (the "Interpretation"), also referred to as AU9332 (issued July 2005)
- A non-authoritative practice aid entitled *Alternative Investments – Audit Considerations* (the "AICPA Practice Aid") based on input from the AICPA's Alternative Investments Task Force and certain AICPA member firms (issued July 2006)

The Interpretation and the AICPA Practice Aid provide guidance to help auditors address the existence and valuation assertions associated with alternative investments because a readily determinable fair value does not exist and, generally, investee fund managers provide limited investment information. These requirements are currently in effect and will impact the way auditors interact with clients and client investee funds. These requirements will also likely impact the relationships between investor entities and investee funds, as well as affect the nature, timing and extent of information shared between these two parties relating to the investee fund's investment portfolio and the investee fund's valuation policies and procedures.

Alternative investments include private investment funds meeting the definition of an "investment company" under the provisions of the *AICPA Audit and Accounting Guide: Investment Companies*, such as hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds, offshore fund vehicles, and fund-of-funds, as well as bank common/collective trust funds. Collectively, these types of investment funds are referred to in the AICPA Practice Aid and herein as "alternative investments." Alternative investments may be structured as limited partnerships, limited liability corporations, trusts or corporations.

The Interpretation was issued in July 2005 to help auditors apply the provisions of AU332 to alternative investments. Since the Interpretation clarified existing guidance, it was effective upon issuance. It provided guidance on the confirmation of an investor entity's interest in an investee fund by the investor entity's auditor. The Interpretation was controversial because it stated that simply confirming investments in the aggregate does not constitute adequate audit evidence with respect to the existence assertion. It stated that, in certain circumstances, it would be necessary to confirm the investee fund holdings on a security-by-security basis. Uncertainty existed over concerns whether auditors would be required to disclaim opinions on investor entities because of scope limitations resulting from the likely unwillingness of investee fund managers to confirm all requested information. Additionally, even if investee fund managers provided portfolio listings, it was unclear what investor entities and their auditors would be expected to do, or even could do, with the information.

The AICPA Practice Aid was issued in July 2006 to clarify certain key points from the Interpretation. The AICPA Practice Aid should be of interest to management of investor entities, including, but not limited to, other investment companies (e.g., fund-of-funds or funds that hold alternative investments), colleges and universities, hospitals and pension plans, as well as to management of the investee funds. Some of these entities invest a small percentage of their investment portfolios in alternative investments, while others invest a substantial percentage. In addition, the underlying investment portfolios held by alternative investments can range from marketable securities to complex derivatives and/or illiquid investments.

Key points

The following paragraphs summarize the key points from the AICPA Practice Aid and the Interpretation.

Management's responsibility

The existence and valuation of an alternative investment is the responsibility of the investor entity's management. Management of the investor entity that uses audited financial statements or other information as support for the valuation of an alternative investment must be prepared to take responsibility, in its own right, for the valuation. Therefore, if management of the investor entity ultimately determines that it is comfortable with the valuation provided by the investee fund, management of the investor entity then takes responsibility for that valuation.

This is particularly reinforced in the AICPA Practice Aid, which states that "management of the investor entity is responsible for the valuation of alternative investment amounts as presented in the investor entity's financial statements" and that "this responsibility cannot, under any circumstances, be outsourced or assigned to a party outside of the investor entity's management." Therefore, although the investor entity's management may look to the investee fund manager for the mechanics of the valuation or to certain third parties to assist with the due diligence and ongoing monitoring efforts, management of the investor entity must have sufficient understanding and supporting information to evaluate and either accept or independently challenge the investee fund's valuation.

To take such responsibility, management of the investor entity must have an effective process and related internal controls in place to ensure a sufficient understanding of their alternative investments. This includes a sufficient understanding of:

- The investment strategies and the manner in which they are employed
- The underlying investment portfolios and the reasonableness and reliability of the inputs and methodologies used for their valuation

The nature, timing and extent of management's process will depend on management's risk assessment of the alternative investments.

Auditor's responsibility

An important element in determining the nature, timing and extent of the audit procedures is the auditor's understanding of the reliability of the process the investor entity's management uses to determine estimated fair value.

The auditor's approach is based on an assessment of the risk of material misstatement of the financial statements. As stated in AU section 312.11, *Audit Risk and Materiality in Conducting an Audit* (AICPA Professional Standards, vol. 1), the auditor's consideration of materiality is a matter of professional judgment, and materiality judgments involve both quantitative and qualitative considerations. The risk of material misstatement includes inherent risk and control risk. Accordingly, the auditor's risk assessment, after considering management's process, will determine the quantity and quality of audit evidence necessary to support the existence and valuation assertions.

The auditor's risk assessment should consider various factors, including, but not limited to:

- The materiality of the alternative investments
- The nature and extent of management's process and related controls associated with the alternative investments
- The degree of transparency available to the investor entity to support its valuation process and related conclusions (including portfolio detail and/or audit reports)
- The nature, complexity and liquidity of the investee funds and their underlying investments

A subtext to the AICPA Practice Aid is that, because the investments presented in an investor entity's financial statements represent the investor entity's assertion, the auditor should not rely exclusively on information obtained from the investee fund manager while ignoring the investor entity's controls, including its monitoring process.

Confirmation process

The AICPA Practice Aid reinforces the Interpretation, which states that simply confirming investments in the aggregate **does not constitute adequate audit evidence** with respect to the existence assertion. The AICPA Practice Aid clarifies that, while confirmation of the holdings of the investee fund on a **security-by-security basis** (or contemporaneous audited financial statements) typically would constitute adequate audit evidence with respect to the existence assertion, the auditor for the investor entity should consider **alternative or additional procedures** directed at the existence of the alternative investments. In addition, Appendix 1 to the AICPA Practice Aid provides an illustrative confirmation for use by auditors.

Despite the guidance included in the AICPA Practice Aid, it is still unclear to many industry participants how the confirmation of the investee fund's holdings on a security-by-security basis adequately addresses the existence assertion. Without information on other assets or liabilities of the investee fund and the investor entity's percentage ownership in the net assets of the investee fund, a security-by-security listing of the underlying investments would not generally provide adequate information for the investor entity or its auditor as to the existence or appropriateness of the recorded value of the alternative investment. Further, without other assurance (which may include management's monitoring controls), the auditor may not have sufficient evidence that the listed investments are genuine.

So, why then is it necessary for the auditor to request confirmation of the investee fund's holdings on a security-by-security basis?

- First, the confirmation request is necessary because confirmation of the investee fund's holdings on a security-by-security basis is required by the Interpretation. In fact, the AICPA Practice Aid reinforces that uncertainty about whether the investee fund manager will provide the requested information does not obviate the auditor's requirement to obtain sufficient appropriate audit evidence – either through confirmation or otherwise. If the confirmation request is not returned to the auditor or the details of the underlying investments are not otherwise provided by the investee fund manager, the auditor should perform alternative procedures. The AICPA Practice Aid is helpful in this respect because it acknowledges that alternative procedures can be performed – the Interpretation was silent on this issue. Even if all the requested information is provided, additional procedures may also be necessary in certain circumstances.
- Second, the confirmation request is necessary because confirmation of the investee fund's holdings on a security-by-security basis, or other adequate information about the investee fund and its investment portfolio, may be helpful or necessary with respect to the existence and valuation assertions. This is because such information should serve to corroborate information the investor entity has represented or directly provided to the auditor with respect to the nature, complexity and liquidity of an investee fund.

Impact to audit report

An auditor cannot audit what management has not done. Therefore, auditors need to evaluate both (i) the adequacy of **management's** process and related documentation to support the amounts in management's financial statements, and (ii) the quantity and quality of audit evidence available to support the **auditor's** opinion on those financial statements. In evaluating the quantity and quality of audit evidence to support specific audit objectives, the auditor should consider factors including, but not limited to:

- The significance of the alternative investments for which neither the underlying security-by-security detail nor audited financial statements was available as of the balance sheet date
- The sufficiency of alternative procedures performed and supporting documentation obtained in situations where the security-by-security detail was not provided to the auditor
- The adequacy of management's process and related internal controls, including those related to the extent of its understanding of the complexity and liquidity of the underlying investment portfolio and related valuation process, and the degree of transparency provided by the investee fund manager

If the auditor concludes that management's valuation procedures are adequate or reasonable and that the underlying documentation supports the valuation, the auditor would generally issue an unqualified audit opinion. In certain circumstances, an auditor might include a so-called "fair value paragraph" (i.e., as an emphasis of matter paragraph) in the audit report because of inherent uncertainty in management's estimated fair value for a significant portion of the investment portfolio. If the auditor concludes that management's valuation procedures are inadequate or unreasonable, or that the underlying documentation does not support the valuation, an auditor could issue a qualified opinion or an adverse opinion. For further discussion of such reporting option, see the *AICPA Audit and Accounting Guide: Investment Companies*, paragraph 11.06.

If an auditor cannot obtain sufficient and appropriate audit evidence to support their audit objectives, the auditor may qualify or disclaim an opinion on the financial statements because of a scope limitation.

Moving forward

With respect to the new guidance in the AICPA Practice Aid, management of both investor entities and investee entities should carefully consider these requirements and evaluate the following:

Degree of transparency

The demands of a growing and more institutional investor base, along with other pressures, have combined to force management of investor entities and investee fund managers to grapple with the issue of transparency. This means that hedge fund managers, in particular, are increasingly being asked to divulge more information on their strategies, portfolios and performance, whereas traditionally they have not been required to provide such information. In addition, private equity fund managers are being asked to provide more transparency around their portfolio company investments at a time when concerns around this information already exist as a result of the recent Freedom of Information Act requests.

The issue of transparency should be considered broadly to incorporate all forms of information and/or access requested by, or provided to, current and potential investors, consultants and others. The focus on the monitoring controls utilized by management of the investor entity is likely to increase their contact with funds, as well as requests for various types of information throughout the year – not just on investor entities' annual reporting dates. As a result, at both the investee and investor levels, portfolio managers, risk management, legal/compliance and finance/accounting personnel need to collectively prepare for and assess these requirements.

Due diligence programs

Management of the investor entity must establish controls over its alternative investments to support the existence and valuation assertions. These controls include:

- Initial due diligence (procedures performed before the initial investment)
- Ongoing monitoring (procedures performed after the initial investment)
- Financial reporting controls (procedures related to the accounting for and reporting of the investment)

The design and effectiveness of these controls are particularly important because they can affect the nature, timing and extent of audit procedures performed by the investor entity's auditor over alternative investments. **In light of the guidance provided in the AICPA Practice Aid, management of investor entities should examine their due diligence programs, related controls and documentation over alternative investments.**

2 | Implications for investor entities

A. Management's procedures and controls

This section addresses an investor entity's procedures and controls over alternative investments and how those procedures and controls can be designed or enhanced to meet the requirements of the audit guidance issued during the past few years.

Directly or through third parties acting on its behalf, management of the investor entity must establish strong procedural controls over the initial due diligence and ongoing monitoring of their alternative investments. These controls may include those listed in Appendix 2 to the AICPA Practice Aid. That list, however, is not intended to be all-inclusive or to be used as a checklist by management or the auditor. Management must design controls appropriate to its organization and the nature and extent of its alternative investments.

To take appropriate responsibility for its portfolio of alternative investments, management of the investor entity must have an effective process and related internal controls in place to ensure a sufficient understanding of their alternative investments. These controls include:

- Initial due diligence (procedures performed before the initial investment)
- Ongoing monitoring (procedures performed after the initial investment)
- Financial reporting controls (procedures related to the accounting for and reporting of the investment)

The design and effectiveness of these controls are particularly important because they can affect the nature, timing and extent of audit procedures performed by the investor entity's auditor over alternative investments. In light of the guidance provided in the AICPA Practice Aid, management of the investor entity should examine its due diligence programs and related controls over alternative investments. In particular, management of the investor entity should evaluate the following, each of which is discussed further below:

1. Design and effectiveness of its due diligence programs
2. Documentation and other evidence available to support its due diligence programs
3. Knowledge, experience and training of the personnel responsible for its due diligence programs and adequacy of related systems
4. Coordination and communication between all parties
5. Financial reporting controls, including valuation

1. Design and effectiveness of due diligence programs

Initial due diligence

It is critical that appropriate controls begin with initial due diligence before choosing to invest in a particular alternative investment. Initial due diligence often incorporates both top-down and bottom-up analysis to evaluate whether a prospective investee fund manager meets the investor entity's risk/return objectives. This would typically involve quantitative and qualitative analysis of a fund manager's investment style and process and an assessment of the effect the investment would have on the investor entity's overall portfolio. Initial due diligence also involves assessing the investee fund manager's personnel, operations, controls, systems, policies and procedures. This is often accomplished through on-site front office and back office reviews, as well as a review of the key legal, tax and compliance issues.

There are a variety of approaches and procedures used by investor entities in their investment decision-making process. Many investor entities have very sophisticated and well-established policies and procedures to identify, select and approve alternative investments, which incorporate quantitative and qualitative analysis, dedicated teams, comprehensive due diligence questionnaires, and formal review and approval processes. Some colleges, universities and other highly endowed institutions rely on third parties to perform pre-investment due diligence, while fund-of-funds typically have their own dedicated personnel. Regardless of which approach is followed, the investor entity is still ultimately responsible for performing sufficient due diligence, making an informed choice, and documenting the process. The degree to which this process is effectively documented has historically varied depending on the sophistication and resources available to the investor entity. The AICPA Practice Aid reinforces the need for management to **document** their initial due diligence process.

Ongoing monitoring

Due diligence should continue after an investment is made. In addition to an ongoing analysis of investment results and risk/return objectives, post-investment monitoring involves ensuring that the investee fund manager – and the investor entity in its role as a prudent investor and fiduciary – continues to have adequate controls, systems, policies and procedures in place.

An effective ongoing monitoring process requires that the investor entity's management (directly or through agents acting on its behalf) has sufficient information on the underlying investee fund and its investments. The investor entity's management may not be able to obtain full transparency into the underlying investments, including a detailed listing of the underlying investment portfolio held by the alternative investments. This is particularly true for hedge funds, which have historically been reluctant to provide such information, and for certain types of investor entities, where the receipt of such information may fall under the Freedom of Information Act. Nevertheless, management should apply a broader view of transparency to incorporate all forms of information and/or access provided by investee fund managers. Therefore, management must find other information or conduct other activities

that will provide valuable information on the alternative investments and the investee fund managers. For example, management of the investor entity can:

- Conduct periodic interviews, including on-site front office reviews, with the investee fund manager to update their understanding of the investee fund's strategy, positions, exposures, key performance drivers, etc.
- Ask about changes in the investee fund manager's detailed valuation policies and procedures, and obtain updated copies or summaries, as applicable. (Note: An excerpt from the investee fund's offering document does not constitute adequate valuation policies and procedures for this purpose.)
- Compare the fund's performance to benchmark returns, peer groups and/or historical returns, to the extent applicable, to see if the return is reasonable
- Review periodic investor reports and letters, including performance and risk statistics, summary or detailed portfolio information, and other information related to leverage, exposure levels, large positions, etc.
- Attend the investee fund manager's annual investor conference, if applicable. (Note: This is common for private equity funds.)
- Obtain and review annual audited financial statements and interim (i.e., quarterly or semi-annual) unaudited financial statements, to the extent available. For audited financial statements, note whether the opinion is qualified and, if so, why. Also note whether there was a change of auditors, or a change in valuation policies (or a change in the amount of "fair valued" investments[1]) or other unusual disclosures associated with related party transactions or otherwise.
- Review SAS 70 reports[2], if available, and ensure that identified user controls are in place.
- Review press reports for significant management, structure, or personnel developments. Inquire about staffing level changes. When key personnel changes occur, consider making background checks, asking for and checking references, and searching the NASD and SEC websites, as applicable.
- Review the Schedule K-1 for each investee fund taxed as a pass-through entity (e.g., limited partnership, limited liability company), as applicable, to determine if it has resulted in any tax considerations.
- Review information on the investee fund's and investee fund manager's assets under management and inquire as to any significant capital changes (up or down).

The activities described above should be documented and maintained in management's files.

As they do with the initial due diligence, some colleges, universities and other highly endowed institutions may outsource ongoing monitoring activities to a third party. If this is the case, the investor entity must develop appropriate monitoring controls and related documentation over its third-party service provider to make sure that its monitoring activities are complete and effective.

1 When effective (fiscal years beginning after November 15, 2007), the new disclosure requirements of Statement of Financial Accounting Standard No. 157, *Fair Value Measurements* ("FAS 157"), will likely provide the investor entity with additional transparency and information relating to the investee fund's fair valuation policies and exposures.

2 Some investee fund managers or fund administrators may have a SAS 70 report on their internal controls. SAS 70 is a standard issued by the AICPA, titled "Reports on the Processing of Transactions by Service Organizations." SAS 70 sets forth the professional standards used by an auditor to assess the internal controls of a service organization and issue a report.

2. Documentation and other evidence to support due diligence programs

It would be prudent for management to expect – and prepare for in advance – the external auditor's request for supporting documentation related to the investor entity's due diligence and valuation practices. Good internal controls include strong documentation related to initial due diligence, ongoing monitoring and financial reporting controls. The following table summarizes some examples of the documentation that may be maintained to provide evidence of certain management controls. To the extent that management does not have sufficient information on its underlying investments, and/or sufficient evidence of such information, the auditor needs to consider the reporting implications.

Area	Illustrative documentation
Selection, evaluation and approval of investee fund managers	• Written due diligence memos, with appropriate review and approvals indicated • Formal due diligence checklists/questionnaires, with appropriate review and approvals indicated • Written minutes (or summaries) of meetings where investment decisions were made
Periodic visits or phone calls to investee fund managers	• Written documentation of visits to or discussions with investee fund managers
Investment policy for asset allocations and valuations	• Written policy that has been adopted/approved by the Investment Committee • Written evidence that policy exceptions were presented to the committee for acknowledgement
Review of audited financial statements	• Written checklist that may address: (a) reconciliation of audited financial statements to recorded balance, (b) roll-forward of audited balance from investee fund's year end to investor entity's year end, and (c) comparison of actual returns to benchmarks, and explanations of significant variances
Review of valuations prepared by investee fund managers, including review of portfolio holdings, key methodologies, inputs and assumptions used	• Written notes on valuations or separate memo documenting understanding of the investee fund manager's process and conclusions • Memo explaining rationale for acceptance of investee fund manager's valuations or adjustments deemed appropriate

3. Knowledge, experience and training of personnel, and adequacy of systems

An important consideration – especially for colleges, universities and other highly endowed institutions – is the required resources to select, monitor, value and report alternative investments, along with the related governance structures in place to oversee these efforts on behalf of the investor entity. As mentioned above, many investor entities have very experienced, dedicated teams, while others (primarily colleges, universities and other highly endowed institutions) may rely on third parties to perform initial and ongoing due diligence. Regardless of which approach is used, the investor entity should maintain a sufficient complement of investment, accounting and finance personnel with an appropriate level of knowledge, experience and training commensurate with the nature, extent and complexity of the investor entity's alternative investment portfolio. The team dedicated to alternative investments should have deep investment experience and extensive experience evaluating and monitoring alternative investments, including the unique tax, legal and regulatory issues.

Equally important are the systems used in the monitoring, oversight, and reporting of alternative investments. Also, given the complexity and risks associated with alternative investments, adequate communication and training are essential.

4. Coordination and communication between parties

To ensure an efficient and effective process, all parties should open the lines of communication and take the time to understand the roles and responsibilities of the other parties, including:

- Independent auditors: What audit procedures will they perform and how does the complexity, liquidity and volatility of the alternative investments impact the nature, timing and extent of those procedures?
- Investee fund managers: What controls and processes have they established, documented and shared with their investors?
- Internal constituents: Is there proper coordination and communication between the personnel within an investor entity who perform and document the due diligence and those who perform accounting and financial reporting for such investments? Do the members of the Audit Committee (if applicable), Investment Committee, front/investment office and back/controller's office fully understand how their roles and responsibilities align?
- Other external parties (e.g., valuation specialists, investment consultants), if applicable: What are their responsibilities and how do they satisfy them? What information is shared with the investor entity, in what form and how often?

5. Financial reporting controls, including valuation

Valuation is one of the two key issues discussed in the Interpretation and AICPA Practice Aid. The AICPA Practice Aid notes that a readily determinable fair value does not exist for many alternative investments. Despite the difficulty of estimating a fair value for alternative investments, they must generally be stated at their fair value, and management is responsible for determining such fair value. The AICPA Practice Aid states that "management of the investor entity is responsible for the valuation of alternative investment amounts as presented in the investor entity's financial statements" and "this responsibility cannot, under any circumstances, be outsourced or assigned to a party outside of the investor entity's management." This means that although management may look to the investee fund manager for the mechanics of the valuation, management of the investor entity must be able to independently evaluate and either accept or challenge the investee fund manager's valuation. In order to take responsibility at this level, management must have an effective process and controls in place, as well as a sufficient understanding of the investee fund's investment strategies, operations, underlying investments, and valuation policies and procedures.

The timing and extent of the investor entity management's understanding is based on its assessment of risk of material misstatement of the financial statements. The extent of management's fair valuation process and related controls should reflect the significance of the alternative investments to the investor entity's financial statements as a whole, the nature of the underlying investments and their risk assessment. In lower-risk situations, such as for alternative investments invested in readily marketable securities (e.g., bank common/commingled trust funds), an effective valuation process ordinarily requires a less sophisticated process and related controls than a higher-risk portfolio of illiquid and complex alternative investments.

An investor entity with an effective valuation process would obtain and review the investee fund's financial reports (e.g., independently audited financial statements, monthly statements). Ideally, the investee fund's reports would include a detailed list of the underlying investments and their fair values, along with other risk metrics. In the absence of detailed data, the investor entity can request other summarized data, such as condensed portfolio data, sector data, etc., that the investee fund may be willing to provide.

Management of the investor entity must do more than simply obtain the detail of the underlying investments to support its assertion regarding the valuation of the alternative investments. However, the investor entity's valuation process need **not** include recalculation of estimated fair values for the alternative investments. Management of the investor entity should understand the characteristics of the underlying investments and the valuation process used by the investee fund manager for the investments held at the balance sheet date. Management of the investor entity should perform an independent, separate valuation only if it becomes aware of erroneous or incomplete assumptions or methodology.

The following points summarize some sound practices related to the financial reporting and valuation for all types of alternative investments, including fund-of-funds:

- Compare the unaudited net asset values (NAV) received by the investor entity at the investee fund's year-end date (often December) to the information included within the investee fund's audited financial statements. Identify and investigate any significant differences.
- Track the timeliness of NAV statements provided by the investee fund manager during the year.
- For hedge funds, consider whether the fund's estimated NAVs received are consistent with the final NAVs received from the investee fund manager or administrator. Identify and investigate any significant differences.

- Obtain the investee fund's Schedule K-1 (for investee funds structured as partnerships, or taxed as such) and review for any federal and state tax liability. Also, compare the capital account information reflected on the Schedule K-1 with the capital account information provided by the investee fund manager and recorded by the investor entity. Identify and investigate any significant differences.
- Compare the investee fund's NAV statements with the value included on the statement provided by the investor entity's custodian, to the extent applicable. Identify and investigate any significant differences.
- On a regular basis, ask the investee fund manager, via phone calls or on-site visits, about any changes in the fund's valuation polices and procedures, including the valuation methodologies, key inputs and assumptions.
- Request and review changes to valuation policies and procedures. Ask whether the investee fund manager employs a consistent valuation process throughout the year.
- Compare the investee fund manager's valuation policies and procedures across different funds in the fund's peer group to identify potential differences in methodologies or key inputs. Ask the investee fund manager to explain any differences in methodologies or inputs.
- When valuations change significantly, find out what caused the change and consider the reasonableness of the explanation. This can be particularly relevant for private equity funds with a discrete number of private investments whose values do not tend to fluctuate period to period.
- Compare cash distributions to previously reported values throughout the year.
- Inquire periodically as to the composition of the investment portfolio and obtain exposure levels, portfolio attribution, large positions, degree of leverage, etc. (primarily for hedge funds).
- For hedge funds, inquire and understand movements to/from "side pocket accounts" maintained by the fund and any related valuation changes for "side pocket investments." (Note: See Appendix B for further discussion of side pockets.)

Valuation may present the single biggest challenge of alternative investments. Therefore, a robust financial reporting and valuation monitoring process that is well documented is essential, and becomes increasingly important as the size and complexity of the portfolio of alternative investments increases. Investor entities should expect their independent auditors to focus on valuation issues. It would be a good idea to discuss with the auditor – sooner rather than later – what audit evidence the auditor will expect from the investor entity to support the adequacy and reasonableness of the portfolio's valuation.

Other financial reporting controls

In addition to exercising its responsibility for determining the fair value of alternative investments, management should take other actions to coordinate the financial statement preparation and prepare for its annual audit. These actions include, but are not limited to, the following:

- Coordinate financial reporting responsibilities between the front and back offices. For colleges, universities and other highly endowed institution, coordinate between the "investment office" and the "controller's office."
- Consider financial reporting controls and related accounting policies over key investment transactions, including investment income, realized gains and losses, and unrealized gains and losses.
- Understand and assess the implications associated with the investee fund's basis of accounting and significant accounting policies and procedures pertaining to the valuation of alternative investments.
- Monitor the level of ownership in each investee fund to determine the proper accounting method (for certain types of investor entities).
- Ensure disclosures related to alternative investments not only meet GAAP standards, but also enhance the transparency of an entity's financial statements given the increasingly high expectations about transparency that exist in the current environment.

B. Management's risk assessment

The AICPA Practice Aid focuses on the existence and valuation assertions associated with alternative investments. Management of the investor entity is responsible for the existence and valuation of the alternative investments presented in the investor entity's financial statements. To exercise this responsibility, the investor entity's management must have a sufficient understanding of the underlying investments in order to design and maintain an effective process and related controls over its alternative investments.

An auditor's approach is based on an assessment of the risk of material misstatement of the financial statements. While management's risk assessment is based on its assessment of the inherent risk of material misstatement in its financial statements, it encompasses other factors as well. One of the challenges that investor entities and their auditors have experienced in addressing the new auditing guidance set forth in the AICPA Practice Aid has been understanding each other's assessment of risk for their respective purposes. Clearly this is an essential element to an efficient and effective audit process.

To design an efficient and effective risk assessment process that addresses the unique risks associated with alternative investments, management must consider all relevant factors. It is clear that several types of alternative investments with varying structures and strategies, each with their own attributes and characteristics, present unique risks. Accordingly, a "one-size-fits-all" approach to assigning risk attributes to alternative investments may not be appropriate.

So, how does management consider all of these factors? In many cases, management has developed its own assessment of risk across its alternative investment portfolio to facilitate its due diligence and ongoing monitoring of its investee funds. There are several quantitative and qualitative approaches that have been used in practice to address this issue. For example, the investor entity may categorize or stratify its portfolio of alternative investments into different risk categories (e.g., "low," "moderate" and "high" risk categories) and/or assign each investee fund a risk rating, score or grade based on specified criteria. Management would then design procedures and controls appropriate for each risk category to provide adequate comfort given the relative risk rating (e.g., more robust procedures and controls for the "high" risk category). This approach involves considerable judgment and requires extensive experience with alternative investments in order to balance all relevant factors for each investment.

Appendix A provides an illustrative AU332 risk assessment and related considerations that capture certain risk factors being considered in practice, including considerations related to the following areas:

Management, governance and service providers

- Quality and experience of fund management
- Role and effectiveness of fund governance
- Quality of service providers

Strategy, structure and key terms

- Nature, complexity and liquidity of strategy
- Nature of the fund's liquidity terms
- Complexity of structure and key terms

Transparency and reporting

- Nature and quality of transparency
- Quality of financial reporting

Internal controls

- Adequacy of infrastructure, personnel and general internal controls
- Design and effectiveness of valuation policies and procedures
- Quality of risk monitoring
- Impact of regulatory compliance matters
- Impact of legal and tax matters

This information is presented for illustrative purposes only, and is not intended to be an all-inclusive list of risk factors that management should consider.

Given the focus in the AICPA Practice Aid on transparency and the nature, complexity and liquidity of the investee funds and their underlying investments, these factors are discussed in more detail below.

Nature and quality of transparency provided by the investee fund manager

Among the factors management should consider in performing its risk assessment is the nature and quality of transparency provided by the investee fund manager. An effective process for supporting fair value estimates of its alternative investments requires the investor entity's management (directly or through agents acting on its behalf) to gather sufficient information on the investment strategy and the underlying investments and to understand the policies and procedures used by the investee fund manager and/or an outside service provider, such as a fund administrator, to value the underlying investment portfolio. In many instances, the investor entity's management may not be able to obtain full transparency into the underlying investment portfolio, including a detailed list of the underlying investment portfolio held by the alternative investments. However, the issue of transparency can also be viewed broadly to encompass all forms of information or access provided by the investee fund manager, including the information and activities described earlier.

Nature, complexity and liquidity of underlying investments of the investee funds

In assessing the risks associated with an investor entity's alternative investments, management should consider the nature of the underlying investments held by the investee funds. Generally, more actively traded, liquid securities held by an investee fund generate the highest level of confidence regarding the valuation and existence assertions at both the investor and investee levels. This is consistent with FAS 157. Conversely, the more complex, illiquid or esoteric the investee fund's investments are, the more effort the investor entity may need to put forth to gain comfort over the investee fund's valuation and existence assertions. The auditor's efforts operate in the same manner as that of the investor entity. The audit effort needed to support the valuation and existence assertions is greater for a more complex or illiquid investee fund than for a less complex and more liquid fund. Therefore, management's risk assessment should consider the complexity of the underlying investments and the policies relating to valuation for each major asset class.

Management may also consider how the ultimate investments are held by the investee fund. The complexity of the structures used by investee funds may affect the degree of transparency provided to or available for the auditor and the investor entity's management with respect to the underlying investment portfolio. For example, information on the underlying investments may be more limited for investments held through multi-tiered fund structures, like master-feeder or fund-of-funds structures, or through various special-purpose vehicles. Such structures may result in further challenges in assessing the existence or valuation assertions.

Typically, there should be a general correlation between the liquidity of an investee fund's investment portfolio and the liquidity terms of the investee fund itself (i.e., redemption provisions). Investor entity management, as part of its initial due diligence in evaluating potential investee funds and ongoing due diligence in monitoring existing investee funds, should consider risks associated with a potential mismatch of liquidity terms between an investee fund's investments and the liquidity terms of the investee fund. Due diligence procedures should also consider the potential for “style drift” for each investee fund and the effect it may have on the matching or mismatching of liquidity.

If we are to assume correlation of liquidity, as described above, management should give special consideration to the investee funds that hold non-public, illiquid investments, such as private equity funds, special opportunity funds, real estate funds and other real asset or natural resource funds. Since these funds hold assets that are generally illiquid and for which no ready market exists, such assets are generally carried at the investee fund manager's estimate of fair value. This yields a higher level of judgment relating to the valuation assertions.

Nature, complexity and liquidity of the investee funds themselves

In performing its risk assessment, management should consider the liquidity of the investee fund itself, and assess the risks associated with any potential mismatch of liquidity between the investee fund's investment portfolio and the liquidity terms of the fund itself.

As noted earlier, the AICPA Practice Aid defines alternative investments to include hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds, offshore fund vehicles, fund-of-funds, as well as bank common/collective trust funds. Some alternative investments, such as bank common/collective trust funds and certain offshore funds, may be highly liquid (e.g., daily liquidity) with underlying investment portfolios consisting mostly of marketable securities. Accordingly, these types of alternative investments may not require significant judgment by the investor entity's management in the assessment of fair value and provide a lower risk of material misstatement to the overall financial statements, on a relative basis. As noted in the AICPA Practice Aid, alternative investments that are themselves invested in marketable securities require a less sophisticated fair value process. Therefore, this publication focuses primarily on hedge funds and private equity/venture capital funds because they are more likely to hold complex and/or illiquid investments and may provide limited, if any, liquidity.

Hedge funds

In general, key structural and operational issues associated with hedge funds complicate their capital structures and related liquidity terms, which may affect fair value considerations of the investor entity. Such issues include, but are not limited to:

- Legal structures
- Liquidity of the underlying investment portfolio
- Timing of cash flows and net asset value determinations
- Prevalence and mechanisms associated with performance-based fee arrangements (e.g., incentive allocations)

For example, the use of a corporate form for most offshore funds (as opposed to a limited partnership form for most domestic funds) imposes certain complexities on the capital structure. In addition, multiple classes of shares or partnership interests with varied terms, as well as master-feeder or other multi-tiered structures, also contribute to the complexity of the fund and issues related to liquidity and fair value.

Investors in domestic and offshore hedge funds can generally withdraw amounts from, or redeem interests in, hedge funds on a monthly, quarterly, semi-annual or annual basis, as the case may be for each fund, subject to certain notice and timing requirements. Such terms (commonly referred to as the "liquidity terms") are governed by the respective investee fund's governing documents (e.g., limited partnership agreement, confidential offering memorandum and articles of association). In particular, the use of "side pocket accounts" may affect the risk assessment. Other liquidity terms include initial lock-ups, the ability to withdraw with penalties (i.e., redemption fees), notice periods, holdbacks and gates. Each of these liquidity terms are described in more detail in Appendix B. Other key terms that may affect the determination of fair value for an investor entity's interest in an investee fund are summarized in Appendix C. Management of an investor entity should be familiar with the various fund terms that may affect the risk assessment with respect to an investee fund, with a particular focus on the investee fund's liquidity terms.

Private equity funds

Redemption upon liquidation or termination of the entity is generally the case for investment fund structures traditionally used for private equity funds (comprising buyout, venture capital, mezzanine and other similar strategies). These entities are referred to as “limited-life funds” pursuant to the AICPA’s Statement of Position 03-4, *Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide Audits of Investment Companies* and AICPA Statement of Position 95-2, *Financial Reporting by Nonpublic Investment Partnerships*. Some closed-end hedge funds employing certain investment strategies (e.g., special opportunities, distressed debt, and so-called “PIPEs,” or private investments in public equities) may also be structured in a similar way. These funds typically do not provide for limited partner-initiated redemptions. Rather, by the terms of their offering documents, these funds have limited lives, often 8 to10 years, with the ability for the general partner to extend the life for a specified period of time (e.g., 2 years). Therefore, unless an investor entity’s interest is sold in the “secondary market,” such funds have limited opportunities, if any, for investor entities to withdraw before the fund is terminated. As a result, interests in private equity funds are less liquid than interests in hedge funds because investors in hedge funds generally have the ability to redeem their interests at their discretion, subject to applicable liquidity terms.

Also, unlike hedge funds, which are generally open to the acceptance of new capital, private equity funds do not continuously raise capital. Rather, investor entities “commit” a specified amount of capital upon inception of the fund (i.e., committed capital), which is then generally “drawn down” over a specified period of the fund’s life (i.e., the investment period) either on a “just-in-time basis” (i.e., as needed by the general partner to make investments or fund the payment of fees and expenses) or at specified intervals. Both the investor entity and its auditor should be aware of the amount of future commitments, not only for disclosure, but also for understanding the projected liquidity of the overall investments in the portfolio.

Private equity funds have, as a predominant operating strategy, the return of the proceeds from the disposition of investments to investor entities. Therefore, upon the disposition of an investment, the proceeds will generally be distributed to the investor entities (including both the limited and general partners), subject to a limited ability of the general partner to “recycle” (i.e., reinvest) the capital under certain circumstances. Distributions can be in the form of cash or securities.

Finally, unlike hedge funds, private equity funds do not routinely acquire (directly or indirectly) market-traded securities or derivatives as part of their investment strategy. Rather, they generally invest in the equity and/or debt securities of private companies.

Funds that specialize in purchasing the existing interests of an investor entity in a closed private equity fund are referred to as “secondary funds.” This type of fund may aim to exploit an existing investor entity’s need for liquidity or desire to avoid future draws on unfunded commitment balances by purchasing these interests, often at a price that is different than the capital balance attributable to the interest. The divergence between the purchase price of the interest and the purchased capital balance (which is often a discount to the investee fund’s NAV but may also be a premium) creates unique valuation considerations for these secondary funds. Because many of these transactions purchased at a discount have a “fire sale” attribute to them, the purchase price actually may not be fair value. Conversely, if the purchase price was derived from negotiations between the buyer and seller after robust due diligence by the buyer, and there is no “fire sale” element to the transaction, the purchase price may be indicative of fair value. Therefore, the investor entity’s management must carefully consider the nature of each transaction and the specific facts and circumstances of each transaction when determining fair value. In each case, the investor entity should document the nature and circumstances surrounding the transaction to support the fair value assertion.

3 | Implications for investee fund managers

The challenges of increased investor due diligence, new auditing requirements, a growing interest in demonstrating operational soundness and stability, and other factors have all combined to force management of investor entities and investee fund managers to grapple with the issues of transparency and more intensive due diligence. As a result, investee fund managers should expect an increase in the nature and extent of due diligence by investors and requests for greater transparency. As described in this document, the request for greater transparency will not come just from management of the investor entity – it will also come from the investor entity's auditor. With respect to such requests for greater transparency, investee fund managers should consider the following:

Anticipate requests and plan response

Investee fund managers should anticipate and prepare for confirmation requests from investor entities' auditors. As described earlier, such requests should include a request for portfolio-level detail. Formulating a policy and approach to such requests will likely require investee fund managers to make an evaluation between:

- Providing certain information they generally consider proprietary
- Meeting investors' expectations by fulfilling these requests
- Addressing legal and compliance considerations relating to providing information to some but not all investors

Carefully consider response

As discussed earlier, the auditor's request for confirmation of the investee fund's holdings on a security-by-security basis is required by the Interpretation, and uncertainty about whether the investee fund manager will provide the requested information does not obviate the auditor's requirement to obtain sufficient appropriate audit evidence. As a result, by and large, it should be expected that auditors will send confirmation requests that include requests for portfolio-level detail similar to those set forth in the AICPA Practice Aid.

To help satisfy the accounting and reporting needs and expectations of their investors, we encourage investee fund managers to carefully consider their responses to these new confirmation requests. Other than the request for portfolio-level detail, the other information requested in the confirmation should not be too controversial or difficult for an investee fund manager to provide. To facilitate the audit of the investor entity, we encourage investee fund managers to respond to these requests for such information in a timely fashion, even if a response to the request for portfolio-level detail is sent separately.

We also encourage investee fund managers to carefully consider these confirmation requests and respond in a manner that balances the needs of their investors and their own policies and obligations with respect to transparency and confidentiality. Many investee fund managers have formulated responses that appear to have met this balance by providing the requested portfolio-level detail and/or providing other adequate information about the investee fund and its investment portfolio. Based on our experience to date, such other information has taken a variety of forms, including, but not limited to, one or more of the following:

- Condensed portfolio detail
- Performance and/or risk reports
- Exposure levels at the asset class, geography, industry and/or position level
- Liquidity analysis of the investment portfolio
- Valuation procedures, in general or by asset class

Some investee fund managers have responded with a standard reporting package, while others address each request separately. Some have even considered scheduling conference calls or hosting web-casts for investors during which they discuss valuation policies and procedures and other matters.

While the portfolio-level detail remains the requirement pursuant to the AICPA Practice Aid, the type of information described above may also be helpful or necessary for the auditor to address the valuation and existence assertions and to corroborate information the investor entity has represented or directly provided to the auditor with respect to the nature, complexity and liquidity of an investee fund.

"One size does not fit all"

It is important for investee fund managers to recognize that requests for greater transparency from their investor entities and from their investor entities' auditors will likely not be consistent, at least for some time. Such inconsistency could result from continued uncertainty about applying the requirements set forth in the AICPA Practice Aid (which this document hopes to alleviate), and some could result from other reasons relating to the application of the considerable judgment required in this process. For example, different investor entities investing the same amount in the same investee fund may approach their due diligence responsibilities differently because of various factors, including different views about risk, different levels of sophistication with respect to their due diligence, different resources, etc. Also, auditors auditing an investment held by different investor entities in the same investee fund may also have different approaches and expectations with respect to the nature and level of transparency needed to satisfy their respective audit requirements. These different expectations and approaches could be driven by various factors, including:

- Different risk assessments by the investor entity and/or their auditor for various reasons, including the significance of the alternative investment to a given investor entity
- The design and effectiveness of the investor entity's procedures and controls
- Different audit approaches

Fund-of-funds, in particular, may face significant challenges with respect to the requirements of the Interpretation and the AICPA Practice Aid because they are both an investor entity (investing in investee funds) and an investee fund for their own investor entities.

4 | Implications for the auditor

A. Auditor's risk assessment

The AICPA Practice Aid focuses on the existence and valuation assertions associated with alternative investments. The auditor's approach is based on an assessment of the risk of material misstatement of the financial statements. As stated in AU Section 312.11, the auditor's consideration of materiality is a matter of professional judgment – and materiality judgments involve both quantitative and qualitative considerations. The risk of material misstatement includes assessing inherent risk and control risk.

With respect to investments in alternative investments, an auditor's risk assessment depends on the particular facts and circumstances, including, but not limited to, the following risk factors, each of which is discussed in more detail below[1]:

1. Significance of alternative investments to the investor entity's financial statements
2. Nature and extent of the investor entity's process and related internal controls associated with the alternative investments
3. Nature and extent of information available to the investor entity to support its valuation process and valuation conclusions (including the availability of portfolio detail and audit reports)
4. Nature, complexity and liquidity of the underlying investments of the investee funds
5. Nature, complexity and liquidity of the investee funds themselves

1. Significance of alternative investments to the investor entity's financial statements

In assessing the risks to the investor entity's financial statements related to alternative investments, auditors need to consider the size of the portfolio devoted to alternative investments and the assessment of materiality at the overall financial statement level or in relation to financial statement assertions for classes of transactions, account balances and disclosures. However, with respect to an investor entity's interests in alternative investments, the relative size is not the only factor used to determine the audit strategy. Auditors also should consider the complexity of the strategies of these investments, the complexity of the entities or legal structures that hold the investments, the level of transparency into the underlying investments, the level of oversight by management and the Investment Committee, and other factors. These other risk considerations are addressed in more detail below.

1 The AICPA Practice Aid includes items (1) through (4), although we have re-sequenced them to reflect the order in which we believe they should be considered. The above list also includes item (5) which was not explicitly included in the AICPA Practice Aid. While we believe there is often an implicit correlation between the nature, complexity and liquidity of the underlying investments (item (4) above) and that of the funds themselves, we have included item (5) to ensure that auditors appropriately focus on this issue as well.

2. Nature and extent of the investor entity's process and related internal controls

In performing the risk assessment of the investor entity's valuation assertion, the auditor should consider the process used by the investor entity's management in developing its fair value estimates and the controls established relative to those estimates. See Section 2 for further discussion of investor entity management's controls and procedures.

In many cases, other parties play a role in the valuation and/or due diligence process. For example, the investor entity's management will often look to the investee fund manager for the mechanics of the valuation. In addition, depending on the extent of the investor entity's investment activities and the relative sophistication of its internal investment process and resources, the investor entity may use the services of a third-party investment consultant to initially select alternative investments (often within the context of its overall investment portfolio) and/or monitor such investments. As stated in the AICPA Practice Aid, management's "responsibility cannot, under any circumstances, be outsourced or assigned to a party outside of the investor entity's management." Therefore, while management of the investor entity may initially rely on the investee fund manager for the valuation of the underlying investments and the determination of its interest in the investee fund, management is not bound by such valuations. Management must have sufficient information to evaluate the investee fund's valuation and either accept or independently challenge it, as appropriate. Also, while management of the investor entity may engage a third-party consultant to select and monitor its alternative investments, it needs to design controls, including monitoring controls, to ensure that its outsourced investment monitoring and due diligence are effective.

As discussed above, regardless of whether other parties are involved in the valuation and/or due diligence process, management must have a sufficient understanding of the nature of the underlying investments, the portfolio strategies of the alternative investments, and the methods and significant assumptions used by the investee fund managers to value the underlying investments. To do this, management must maintain a sufficient complement of personnel with an appropriate level of knowledge, experience and training commensurate with the risks associated with its alternative investments. In addition, management should document its understanding of the nature of the underlying investments and the associated assumptions and methodologies used by the investee fund managers to value underlying investments.

As part of the overall risk assessment, the auditor uses professional judgment in assessing control risk (i.e., the risk that a potential material misstatement will not be prevented or detected on a timely basis by the entity's internal control). The auditor's assessment of control risk is based on an evaluation of the effectiveness of an entity's internal control to prevent or detect material misstatements in the financial statements. Since this assessment should generally be applied in the context of a particular process, it should be applied when obtaining an understanding of processes and controls, and when evaluating and validating internal controls around alternative investments. This may require that the auditor understand, evaluate and, if appropriate, validate varying controls over different classes or types of alternative investments held by the investor entity. As stated above, the controls to be tested may include those listed in Appendix 2 to the AICPA Practice Aid. As previously noted, however, that list is not intended to be all-inclusive or to be used as a checklist by the investor entity's management or the auditor. Management must design controls appropriate to its organization and the nature and extent of its alternative investments.

The assessment of control risk determines the nature and extent of controls comfort, if any, from the effective operation of internal controls. The nature of controls testing relates to the purpose and type of audit procedures. The extent of controls testing relates to the quantity and quality of audit evidence needed to demonstrate that controls operated effectively throughout the period of reliance. The level of comfort obtained from testing the controls drives an auditor to determine the nature and extent of substantive procedures to be performed.

If the auditor believes that controls are unlikely to be effective as they relate to existence or valuation of alternative investments, or believes that evaluating their effectiveness would be inefficient, the auditor would assess control risk for those assertions at the maximum, resulting in obtaining little or no controls comfort from the effective operation of internal control. Conversely, if the auditor assesses control risk at a low level, then significant controls comfort can be obtained by evaluating and validating the effectiveness of the design and operation of internal controls. Assessing control risk below the maximum level requires that the auditor:

- Identify specific controls relevant to specific assertions
- Test controls
- Conclude on the assessed level of control risk

In order to rely on controls around alternative investments, an auditor must also validate, through testing, the design and operating effectiveness of the related internal controls, including those in the information technology environment.

3. Nature and extent of information available to the investor entity

Management of the investor entity is responsible for the valuation of the alternative investments presented in the investor entity's financial statements. To exercise this responsibility, the investor entity's management must have a sufficient understanding of the underlying investments in order to design and maintain an effective process to support fair value estimates of its alternative investments. The timing and extent of management's procedures is based on its assessment of the inherent risk of material misstatement in its financial statements. In higher risk situations, management should have a better understanding of the underlying investments and the process used to value such investments. Management must also have sufficient information to understand, evaluate and either accept or independently challenge the investee fund's valuation policies and application thereof.

Management of the investor entity must also have a sufficient understanding of the nature of the investee fund's underlying investments, the portfolio strategy employed and the policies and procedures used by the investee fund manager and/or an outside service provider, such as a fund administrator, to value the underlying investment portfolio, including the inputs, methods and key assumptions used. Such understanding should be documented in the investor entity's files.

An effective process for supporting fair value estimates of its alternative investments requires the investor entity's management (directly or through agents acting on its behalf) to have sufficient information on the underlying investments. Therefore, an auditor needs to assess the nature and extent of information available to management and the documentation and support of such information in management's files. Good internal controls include strong documentation related to both initial and periodic ongoing due diligence. To the extent that management does not have sufficient information on its underlying investments, and/or sufficient evidence of such information, the auditor needs to consider the internal control and financial statement reporting implications.

4. Nature, complexity and liquidity of underlying investments of the investee funds

In assessing the risks associated with an investor entity's alternative investments, the auditor should consider factors including, but not limited to, the nature of the underlying investments held by the investee funds, the policies relating to valuation for each major asset class, and the manner in which investments are held by the investee fund.

As discussed in Section 2, the auditor's efforts operate in the same manner as that of the investor entity. Generally, more actively traded, liquid securities held by an investee fund generate the highest level of confidence regarding the valuation and existence assertions. This is consistent with FAS 157. The audit effort needed to support the valuation and existence assertions is greater for a more complex or illiquid investee fund than for a less complex and more liquid fund.

The investor entity's auditor should also consider management's policies relating to obtaining an understanding and evidence of the composition of the investee fund's investment portfolio and the valuation policies relating thereto (e.g., what are the valuation inputs and methodologies, how much of the portfolio is fair valued, how often is the portfolio priced). The auditor, in developing a risk assessment, must also consider how the ultimate investments are held by the investee fund. The complexity of the structures used by investee funds may affect the degree of transparency provided to or available for the auditor and the investor entity's management, with respect to the underlying investment portfolio. For example, information on the underlying investments may be more limited for investments held through multi-tiered fund structures like master-feeder or fund-of-funds structures, or through various special-purpose vehicles. Such structures may result in further challenges in assessing the existence or valuation assertions.

As discussed in Section 2, there should be a general correlation between the liquidity of an investee fund's investment portfolio and the liquidity terms of the fund itself (i.e., redemption provisions). As part of its risk assessment, the auditor should consider the potential for liquidity mismatch between an investee fund's investments and the liquidity terms of the investee fund itself, as well as the potential for "style drift" for each investee fund and the effect it may have on liquidity.

5. Nature, complexity and liquidity of the investee funds themselves

In performing its risk assessment over an investor entity's portfolio of alternative investments, the auditor should consider the liquidity of the investee funds themselves, with a particular focus on hedge funds and private equity funds. When assessing the risk of the investment, management of the investor entity and the auditor should understand the nature and extent of the investee fund's liquidity terms. For the following reasons, funds that provide less liquidity (i.e., less frequent redemption rights) may be considered higher risk than funds with greater liquidity:

- Investor entities are not as readily able to redeem their interests in the fund.
- There is an expected correlation between the liquidity terms of the fund itself and the liquidity of the investee fund's underlying investment portfolio.

Therefore, investee funds with longer lock-up periods and/or notice periods may suggest that the investee fund is less liquid – and therefore higher risk – than funds with shorter or no lock-up periods. This is because investors in funds with shorter or no lock-up periods generally have the ability to redeem their interests more frequently. Also, since investor entities lose any redemption rights with respect to the portion of the underlying investments designated in "side pocket accounts" (as explained in Appendix B), the use of such mechanisms may create inherent difficulties in assessing fair value. Therefore, it is important to determine if investments held in the side pocket accounts are material to the investor entity's overall capital balance, and for management to understand the nature of the fair value policies and procedures over the related side pocket investments. Further, the imposition of the "gate" could indicate significant redemptions from the fund. Depending on the liquidity of the underlying investments in the fund, this could affect the amount and timing of the investor entity's redemptions from an investee fund and, therefore, affect the investor entity's assertion related to fair value (i.e., consider whether the net asset value of the investment should be discounted).

Some of these terms could affect the investor entity's net realizable value with respect to an investee fund. For example, the investor entity and the auditor should be aware of situations where the holdback period (described in Appendix B) has ended and proceeds have either not been received from the investee fund or have been received but not for the full amount. This could indicate an issue associated with the net realizable value of the receivable from the investee fund with respect to such holdback amount.

When assessing the risk of the investment, the auditor (and management of the investor entity) should ensure they understand the nature and extent of the investee fund's liquidity terms in combination with other factors. For example, since private equity funds have limited opportunities, if any, for investor entities to withdraw before the fund terminates (other than through a sale in the "secondary market"), interests in private equity funds may be considered less liquid than interests in hedge funds. Therefore, simply from a liquidity perspective, private equity funds may be considered higher risk. Other factors, however, such as the possibility of a sale in the "secondary market" and/or the higher level of transparency often provided by private equity fund managers to their investors may serve to mitigate the higher risk. Private equity fund managers tend to provide significant transparency to investors because their portfolios consist of positions that were "privately negotiated" with little access to the transactions through the public market.

Summary of auditor's risk assessment

As noted throughout this section, with respect to investments in alternative investments, the auditor's risk assessment depends on the particular facts and circumstances, including, but not limited to, the following risk factors:

- Significance of alternative investments to the investor entity's financial statements
- Nature and extent of management's process and related internal controls associated with alternative investments
- Nature and extent of information available to management to support its valuation process and valuation conclusions
- Nature, complexity and liquidity of the underlying investments of the investee funds
- Nature, complexity and liquidity of the investee funds themselves

In determining the nature, timing and extent of audit procedures, the auditor must consider all of these factors. It is clear that several types of alternative investments with varying structures and strategies, each with their own attributes and characteristics, present unique audit risks. Accordingly, a "one-size-fits-all" approach to auditing an investor entity's interests in various alternative investments may not be appropriate. To design efficient and effective audit procedures that address the unique risks associated with each investment, all relevant factors must be considered. As with management's risk assessment, there are several approaches to addressing this issue. One approach would be to categorize or stratify the investor entity's portfolio of alternative investments by the auditor's perceived risk assessment into "low," "moderate" and "high" risk categories. The auditor would then design procedures for each category to provide adequate comfort given the relative risk rating (e.g., more robust audit procedures for the "high" risk category). For example, based on the risk assessment, the auditor may categorize the portfolio of alternative investments as follows:

Low risk

- Lower relative risk than other categories
- Heavier reliance on management's process and controls
- Some substantive testing of valuation and existence assertions

Moderate risk

- Moderate relative risk compared with other categories
- Moderate reliance on management's process and controls
- More substantive testing of valuation and existence assertions

High risk

- High relative risk compared with other categories
- Low reliance on management's process and controls
- Heavy substantive testing of valuation and existence assertions

This approach, which involves considerable judgment by the auditor, should consider all relevant factors for each alternative investment. For example, if the auditor considered the liquidity of the alternative investment as the only relevant factor in categorizing risk, all closed-ended private equity funds would default to a "high" risk rating. If the auditor considered other factors, such as the transparency of portfolio holdings and quality of quarterly investment summary disclosures, the risk assessment for those private equity funds may change to "moderate" or "low."

Also, given the varying terms, structures and strategies within different types of alternative investments, it is likely that the alternative investments within a general category (e.g., hedge funds, private equity funds) may be placed into different risk categories. For example, a hedge fund that holds highly liquid, marketable securities and provides monthly liquidity may be categorized as "low" risk, while another hedge fund that holds liquid and illiquid investments and has a longer lock-up period may be considered "moderate" or "high" risk. The same could apply for funds that employ a similar investment strategy but are structured differently.

In addition, a fund-of-funds investment might be categorized initially as "high" risk given the inherent liquidity issues and transparency constraints with respect to the ultimate underlying investments. If, however, the fund-of-funds manager has effective procedures and strong internal controls and periodically provides detailed or summary information on portfolio funds, the risk assessment might change to "moderate" or "low" risk.

As discussed in Section 2, in many cases, management may have developed its own stratification of risk across its alternative investment portfolio to facilitate its due diligence and ongoing monitoring of the investee fund managers. Though the factors management considered in their stratification effort may vary from those of an auditor, the auditor should understand management's approach and any significant differences that could influence their ultimate risk categorization of the investments. An efficient approach may be for the auditor to obtain and assess management's risk assessments, corroborate the information, and then design appropriate audit procedures around each category.

B. Addressing the existence and valuation assertions

As with any audit area, an auditor's approach is based on an assessment of the risk of material misstatement of the financial statements. Accordingly, the auditor needs to consider the quantity and quality of audit evidence to be obtained when assessing risks and designing audit procedures. There is a direct relationship between the risk of misstatement and the quantity of audit evidence needed – the greater the risk, the more audit evidence is required. Also, the quantity and quality of audit evidence are interrelated because the higher the quality of audit evidence, the less quantity of audit evidence may be required.

The evaluation of the quality of such evidence is subject to the auditor's professional judgment. The AICPA Practice Aid highlights that the quantity and quality of the audit evidence necessary generally increases as:

- The percentage of alternative investments to total assets and the total investment portfolio increases
- The nature, complexity and volatility of the underlying investments increases

Refer to Exhibit I and related discussion in the AICPA Practice Aid for further information.

In general, a direct relationship also exists between the quality of the audit evidence and the nature and extent of the information provided by the investor entity and/or the investee fund manager as of a date closest to the investor entity's balance sheet date. As the quality and extent of information as of the investor entity's year end increases, so does the quality of the audit evidence available. Because of certain inherent issues associated with alternative investments, auditors may face challenges in obtaining the same quality and quantity of audit evidence across an investor entity's portfolio of alternative investments. The evaluation of the quality and quantity of audit evidence is subject to the auditor's professional judgment. Table 4A is a non-all-inclusive list of the various types of audit evidence an auditor may receive and an illustrative assessment as to its quality.

Table 4A

Information available	Quality
US GAAS/GAAP audited financial statements of the investee fund, including detailed schedule of investments, as of the investor entity's balance sheet date	Highest
US GAAS/GAAP audited financial statements of the investee fund, including condensed schedule of investments, as of the investor entity's balance sheet date	High
Unaudited detailed list of the investee fund's underlying investments as of the date of the investor entity's balance sheet date, particularly to the extent the investments are highly liquid	High
Non-US GAAP audited financial statements of the investee fund, including detailed schedule of investments, as of the investor entity's balance sheet date, along with reconciliation to US GAAP	Moderate/High
Unaudited investee fund's condensed schedule of investments as of the date of the investor entity's balance sheet date	Moderate
Unaudited detailed listing of the investee fund's underlying investments as of a date other than the investor entity's balance sheet date	Moderate
Audited financial statements of the investee fund, including a detailed or condensed schedule of investments as of a date other than the investor entity's balance sheet date	Moderate
Confirmation with the investee fund manager or with a third-party administrator of the investor entity's interest in the investee fund (e.g., number of units held or percentage ownership, and value of the investor entity's proportionate share of net assets/partners' capital) as of the investor entity's balance sheet date	Moderate/Low
Limited visibility into the underlying investments	Low

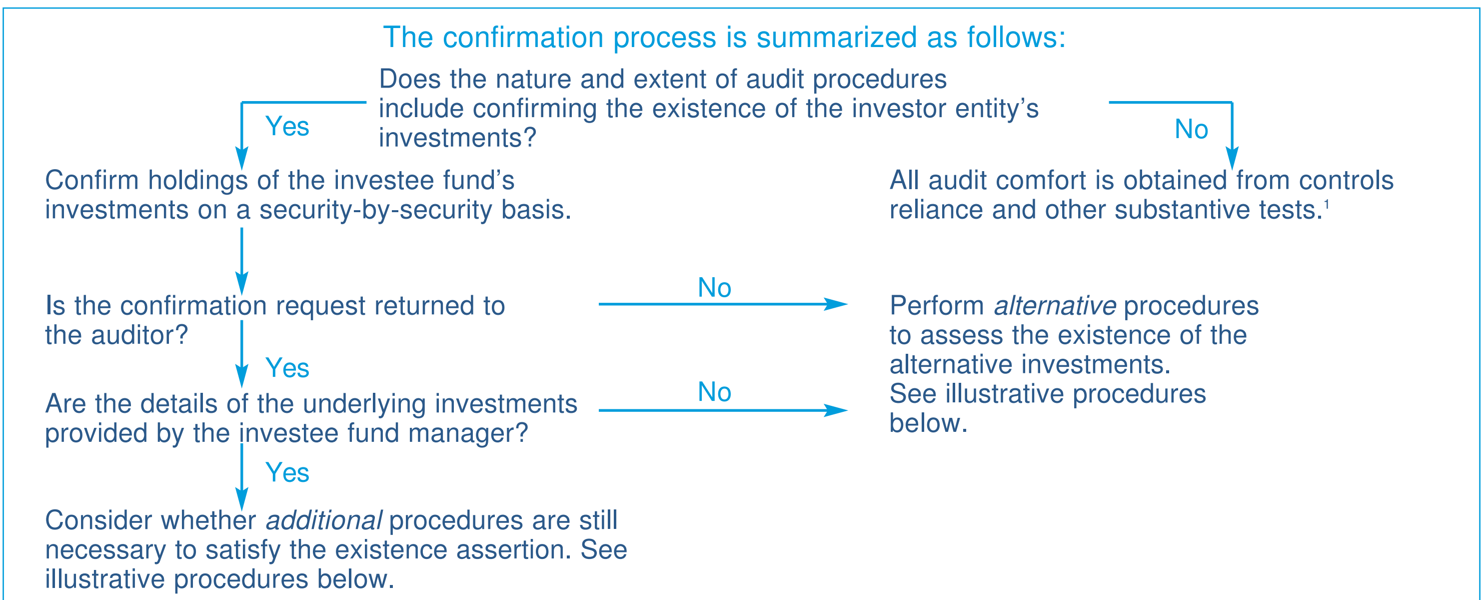
Existence assertion

The existence assertion addresses whether the alternative investments exist at a given date. The occurrence assertion addresses whether the alternative investment transactions reported in the financial statements actually occurred.

Confirmation process

The AICPA Practice Aid provides guidance on the confirmation process that auditors should incorporate into their audit approach. According to the AICPA Practice Aid, simply confirming investments in the aggregate does not constitute adequate evidence with respect to the existence assertion. Rather, the AICPA Practice Aid states that, if the auditor concludes that the nature and extent of audit procedures should include confirming the existence of the entity's investments, confirmation of the holdings of the alternative investments on a security-by-security basis typically would constitute adequate audit evidence with respect to the existence assertion. Appendix 1 to the AICPA Practice Aid includes an illustrative confirmation for alternative investments. This confirmation is illustrative only and may be enhanced or modified if appropriate. For example, for private equity funds, it may be appropriate to also confirm the investor entity's share of committed capital and the unfunded capital commitment as of the reporting date. It may also be appropriate to create different confirmations for an investee hedge fund (domestic and offshore funds) or an investee private equity fund.

If the confirmation request is not returned to the auditor or the details of the underlying investments are not otherwise provided, the AICPA Practice Aid states that the auditor should perform alternative procedures to assess the existence of the alternative investments. Even if the auditor obtains a detailed confirmation of the investee fund's holdings, the AICPA Practice Aid states that the auditor may need to perform additional procedures, depending on the significance of the alternative investments to the investor entity's financial statements. Considerable auditor judgment is required to determine whether the auditor has sufficient evidence to satisfy the existence assertion.



1 It would be unusual for the nature and extent of audit procedures to not include confirming evidence of the investor entity's alternative investments.

Illustrative alternative or additional procedures

Alternative or additional auditing procedures include, but are not limited to, the following:

1. Observe management site visits or listen to telephone calls to investee funds (or review documentation of such calls or visits).

Observation: Depending on the timing of management's site visits or telephone calls to investee funds and the willingness of the investee fund manager to allow participation by the auditor, auditors may or may not be able to actually observe such visits or calls. However, management of the investor entity, as part of its due diligence process, should maintain adequate records of such visits or calls, which auditors can review.

2. Review executed partnership, trust, limited liability corporation or similar arrangements.

Observation: The ability and extent to which executed documents help satisfy the existence assertion depends on factors such as the nature of the investee fund and the aging of the investment. For example, the limited partnership agreement for a private equity fund may include a list of each limited partner and their corresponding capital commitment. Reviewing executed copies of such documents may provide evidence as to the existence assertion, especially when the investment is relatively new. However, if an investment in a private equity fund is aged (i.e., greater than one year), reviewing the partnership agreement would give the auditor less evidence of the ownership of that alternative investment as of a current reporting date.

The limited partnership agreement for a hedge fund does not typically provide an investor list. Rather, each limited partner separately executes a limited partnership agreement and related subscription document upon admission to the hedge fund. Limited partners may execute additional subscription documents or other documents upon subsequent subscriptions to the fund. Limited partners may also execute redemption requests upon providing notice of their intention to redeem from an investee fund.

The auditor might obtain adequate audit evidence by reviewing executed documents, along with confirmation of related capital activity, with the investee fund manager or with a third-party fund administrator, and vouching the related cash.

3. Inspect other documentation supporting the investor entity's interest in the fund (e.g., confirmation of subscription, periodic statements, tax forms).

Observation: Upon subscription to a fund, the investee fund manager or fund administrator may provide a "confirmation" of the investment made. Typically, the investee fund manager or fund administrator also provides periodic statements reflecting an investor entity's interest in the fund, related capital account or number of shares/units held. Such information may be useful audit evidence for the existence assertion, especially when it is supplied to the investor entity directly by a third-party fund administrator. Alternative investments structured as domestic partnerships (or taxed as such) would also be required to provide limited partners with a Schedule K-1, which reports the components of taxable income, the capital account balance and related activity, as well as the percentage of interest of such investor entity in the fund. Auditors need to keep in mind that, like most alternative investments, funds structured as domestic partnerships predominantly have a December 31 year end. For such information to be most useful to the auditor of the investor entity, management of the investor entity with a different year end should reconcile such calendar year tax information to the audit period and year end of the investor entity.

4. Review periodic investor/partner statements from the investee fund or administrator/custodian reflecting investment activity and compare such activity with the investor entity's records.

Observation: As noted above, the investee fund manager or fund administrator typically provides periodic statements reflecting an investor entity's interest in the fund, related capital account or number of shares/units held. Comparing such documentation reflecting investment activity to the records of the investor entity may provide the auditor with valuable audit evidence, especially when such information is supplied directly to the investor entity by a third-party fund administrator.

5. Review annual audited financial statements.

Observation: In most cases, alternative investments are required to have an annual audit. The timing of the audit depends on factors primarily driven by the investee fund's fiscal year end and the nature of its underlying investment portfolio. The vast majority of alternative investments have a December 31 year end. Some offshore hedge funds, however, may have a different year end, often June 30. Reviewing annual audited financial statements (or, to a lesser extent, quarterly or semi-annual unaudited financial statements) may be useful in satisfying the existence assertion, especially when the financial statements include additional information detailing an investor entity's interest in the fund. Considerations related to the use of such financial statements are discussed in further detail later in this section.

6. Vouch relevant cash receipts and disbursements.

Observation: Comparing cash activity reflected in the records of the investor entity with the corresponding cash movements reflected in bank or brokerage statements generally provides the auditor with valuable audit evidence.

Valuation assertion

The valuation assertion addresses whether alternative investments have been included in the financial statements at the appropriate values. This guidance addresses alternative investments required to be carried at fair value.

Illustrative procedures

The auditor's consideration of the valuation assertion typically begins with understanding the process used by the investor entity's management to develop its fair value estimates and the controls established relative to those estimates.

As discussed earlier, management of the investor entity is responsible for the valuation of the alternative investment amounts presented in the investor entity's financial statements. The AICPA Practice Aid states that this responsibility **cannot be outsourced or assigned** to a party outside of the investor entity's management. While management can look to other parties for the mechanics, review, accounting or oversight of the valuation – such as the investee fund manager, administrator/custodian or a third-party investment consultant – management must have sufficient information to evaluate the investee fund's valuation, and either independently challenge it or accept it, as appropriate. In certain circumstances, challenging the investee fund's valuation may cause the investor entity to modify it in some way.

The investor entity's auditor needs to develop a solid understanding of the investor management's process and controls to determine the estimated fair value of its alternative investments in order to assess how they affect the nature, timing and extent of the auditing procedures. The AICPA Practice Aid suggests that the auditor test management's fair value estimates using one or more of the following approaches as of the balance sheet date:

a. Confirm the alternative investment
b. Review and test the investor entity's process and related data
c. Use audited financial statements
d. Review recent transactions

These approaches are described in more detail below. To the extent that the investor entity's management estimates the fair value of a significant portion of its alternative investments as of an interim date, management of the investor entity needs to obtain sufficient information to record such investments at fair value as of its balance sheet date. In those cases, the auditor must test both the investor entity's estimation process as of the interim date and the investor entity's roll-forward process to the reporting date.

The auditor must also consider how much management of the investor entity relies on the information reported to it by the investee funds. If management of the investor entity relies significantly on the investee fund manager's valuations and valuation process, management must first ascertain whether it is appropriate to do so by gathering as much information about each of the investee fund managers as possible. Much of this information is obtained and analyzed as part of management's initial and ongoing due diligence procedures described in the AICPA Practice Aid and discussed in Section 2.

The auditor should ensure that it understands where within the investor entity's organization the due diligence and monitoring process takes place. The auditor should not only review the procedures performed by operational and accounting personnel, but also focus on the functions performed by areas such as portfolio management, risk management and the legal department. In some cases, the responsibility for the due diligence programs and related documentation is dispersed within an investor entity's organization. It is also helpful for the auditor to understand the type of data that is presented to management, Valuation Committees and/or the board of directors at the investor entity with respect to alternative investments.

Where management of the investor entity has determined that they are NOT comfortable relying on an investee fund's reported value, management must arrive at its own estimate of fair value. This is typically done with the help of the underlying investee fund manager because the information about the portfolio investments that would facilitate the valuation process is often not totally transparent or available to the investor entity. For example, if the investee fund reports on a tax basis (rather than US GAAP), the investor entity should contact the investee fund manager to obtain the necessary information to arrive at fair values in accordance with US GAAP for the investee fund's investment portfolio.

The approaches described in the AICPA Practice Aid for the auditor to test management's fair value estimates are each stated below, with additional guidance provided on the use of financial statements and the review of recent transactions.

a. Confirm the alternative investment

The AICPA Practice Aid states that if the auditor determines that the nature and extent of auditing procedures should include testing the measurement of the investor entity's investment, simply receiving a confirmation from the investee fund of its underlying investments, either in the aggregate or on a security-by-security basis, does not, in and of itself, constitute adequate audit evidence with respect to the valuation assertion. The extent of additional procedures is directly related to the assessed risk of material misstatement of the financial statements.

b. Review and test investor entity's process and related data

A confirmation on a security-by-security basis may provide the auditor with corroborating evidence to support the data used or considered by the investor entity's management in its valuation process. However, if detailed information, such as a description of each investment, ownership percentage, shares owned and estimated value is not available, then the auditor should look to other information that management of the investor entity used in its valuation.

Such other information may include detailed descriptions of the investee fund process to determine fair value and the investor entity's assessment of that process. It may also include a review of Valuation or Investment Committee minutes or other memoranda or summaries that document key valuation assessments and judgments made in the process.

Often, management uses a wide variety of information to assess valuation. This includes management's understanding and supporting documentation related to the valuation controls at the investee fund manager, as well as information it receives on a periodic basis. As part of its ongoing due diligence, the investor entity may receive full transparency to the investee fund's underlying portfolio or something less, such as material positions. Alternatively, they may receive other information, such as exposure reports or benchmarking data, which they may use to assess the reasonableness of the returns provided by investee fund managers. For instance, a fixed-income hedge fund may not provide an investor with full transparency to the fund, but may give the investor key data with respect to the portfolio that the investor may in turn use to track the fund against observable benchmarks. Such data includes the duration of the portfolio, weighted average maturity, weighted average coupon, portion of the portfolio that is hedged, etc. The investor entity may then use this information to derive expectations related to the investee fund, which are then compared to actual returns.

Another example would be an investee fund invested in over-the-counter derivatives. The investee fund may provide enough information related to the portfolio, such as its sensitivity relative to the benchmark (e.g., the delta of the portfolio) that it could be tracked against an observable market. In the absence of sufficient audit evidence, especially when the year end of the investee fund does not coincide with that of the investor entity, auditors may consider testing these analytical procedures by performing independent analytical procedures using publicly available information or testing the assumptions used.

c. Use audited financial statements

The investor entity should provide the auditor with the most recent financial statements of each investee fund and the accompanying audit report. The investor entity should also provide the auditor with the reconciliation of such financial statements with the investment balance recorded by the investor entity. In reviewing these financial statements and related reconciliations, the auditor should consider the factors discussed below.

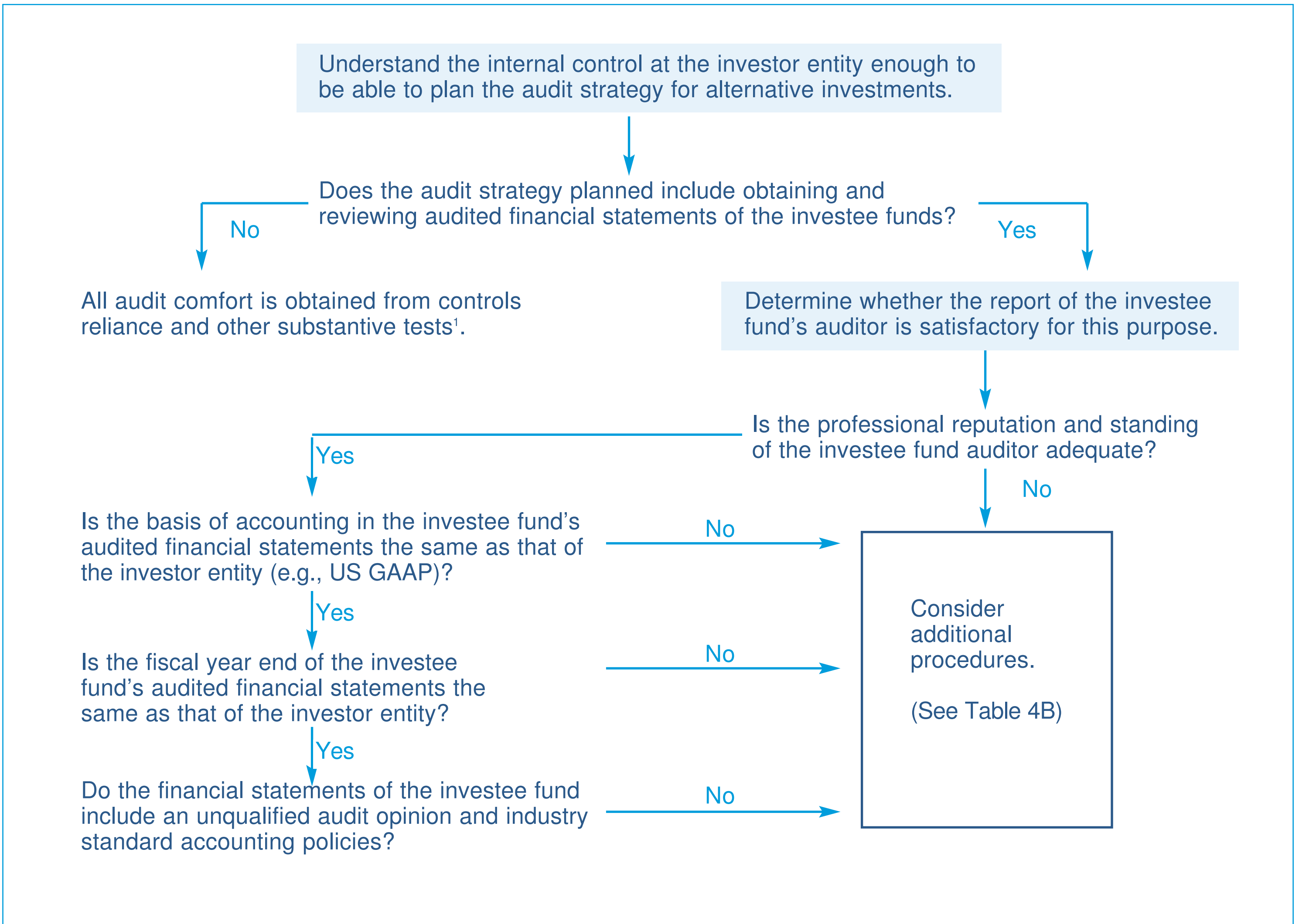
Obtain and review available financial statements

In general, coterminous financial statements of the investee fund that are reported on the same basis of accounting as those of the investor entity and which have been audited by an auditor whose report is satisfactory to the investor entity's auditor, for this purpose, may constitute sufficient evidential matter.

Upon reviewing the investee fund's financial statements, however, the auditor may conclude that additional evidence is needed because of factors such as:

- Unfamiliarity with, or questions surrounding, the professional reputation and standing of the investee fund's auditor
- Significant differences in fiscal year ends between the investor entity and the investee fund
- Significant differences in the basis of accounting between the investor entity and the investee fund resulting in significant differences in the accounting principles applied
- Questions regarding the audit opinion for the investee fund and/or its accounting policies
- Timing of the investor entity's audit that precludes receipt of the audited financial statements of the investee fund
- Other factors that cause management of the investor entity discomfort with relying on an investee fund manager's estimate of value

The following decision tree is a tool to help the auditors of investor entities as they consider the use of financial statements of investee funds.



As reflected above, if the investor entity and the investee fund have the same year end and basis of accounting, then the audited financial statements of the investee fund and the accompanying auditor's report may provide significant audit evidence regarding the valuation of the investment. To the extent that the investor entity and the investee fund have different year ends and/or a different basis of accounting, the auditor may need to perform additional procedures.

1 It would be unusual for the audit strategy to not include obtaining and reviewing the most recent audited financial statements of the investee funds.

If, because of the issues listed above (or others), the auditor needs more evidential matter, the auditor should perform additional procedures to gather the additional evidence. The nature, timing and extent of these additional procedures is a matter of professional judgment after considering factors such as the materiality of the investment in relation to the financial statements of the investor entity. These procedures may include those listed in Table 4B below.

Table 4B

Factors impacting use of audited financial statements	Illustrative additional procedures
Professional reputation and standing of the investee fund's auditor	• Investigate the professional reputation and standing of the investee fund's auditor. • Request that the investor entity apply, or have the auditor apply, appropriate procedures to the financial statements and/or the underlying records. • Request that the investor entity call or visit the other auditor to discuss audit procedures followed and the results thereof. Review the audit program and/or working papers of the other auditor, to the extent permissible.[1] While it may be appropriate for auditors to observe such visits (or to review documentation of the calls or visits), the investor entity retains primary responsibility.
Significant differences in fiscal year ends	• Obtain and review interim financial information supplied by the investor entity related to the investee fund and test their tracking analyses. • Obtain from the investor entity any roll-forward or analytical procedures over the investment balance from the date of the investee fund's year end to the date of the investor entity's year end.
Significant differences in basis of accounting	• Obtain a reconciliation of the reported amounts to US GAAP. Such reconciliation should be prepared by the investor entity or obtained by the investor entity from the investee fund manager and reviewed by the investor entity. • Obtain documentation from the investor entity assessing differences in the basis of accounting and the effect on the investment balance. For investments not held by the investee fund at fair value, review the independent assessment of fair value provided by the investor entity's management.[2]
Qualified opinion and/or unusual accounting policies	• Review financial statements of the investee fund to assess the potential effect of a qualified opinion or unusual accounting policies. • Obtain documentation from the investor entity assessing the potential effect of a qualified opinion or unusual accounting policies.

1 To the extent that the investee fund's auditors have policies that prevent an investor from contacting them directly, investor entity auditors need to consider alternative procedures.

2 This is typically done with the help of the investee fund manager whenever possible. For example, if the investee fund reports on a tax basis (rather than US GAAP), management of the investor entity should contact the investee fund manager to obtain the necessary information to arrive at fair values for the investments held by the investee fund. For real estate funds, for instance, the investee fund manager may have independent appraisals. Management of the investor entity may obtain and review the appraisals to support its fair value assertions.

Reconcile financial statements to investment balance

In addition to assessing the adequacy of the audited financial statements of the investee funds based on the factors set forth above, the auditor should obtain management's reconciliation of the investee fund's financial statements with the investor entity's recorded investment balance.

Management's ability to reconcile the investee fund's audited financial statements to the investor entity's recorded investment balance depends on various factors, such as the nature of the information provided in the financial statements and the investee fund's capital structure. In certain situations, it may be easy for the investor entity to reconcile the recorded investment balance with information in the investee fund's audited financial statements. In other situations, it may be difficult. Consider the following examples:

- **Supplemental information:** In some cases, the audited financial statements include supplemental information containing individual investor capital balances and related activity. In such situations, the investor entity should compare the recorded investment balance with the corresponding capital balance presented as supplemental information to the investee fund's audited financial statements and reconcile any differences.
- **Unitized capital structures:** In the case of hedge funds that maintain unitized capital structures (e.g., most offshore funds structured as corporations), the audited financial statements should present the net asset value (NAV) per share for the various classes or series outstanding at year end. The investor entity may decide to compare such NAVs reflected in the audited financial statements with those used by the investor entity to record its investment balance.
- **Analytical procedures:** In other cases, it may be more difficult for management to reconcile the audited financial statements for the investee fund as a whole with the investor entity's recorded investment balance. In those cases, the investor entity may decide to perform analytical procedures over the investment balance for reasonableness. For example, it may be possible for the investor entity to reconcile its investment balance to the product of the total capital/net assets of the investee fund reflected in the audited financial statements and the investor entity's percentage interest. Such percentage interest can be obtained from information provided by the investee fund manager and/or the percentage interest reflected for the investor entity on the Schedule K-1 it receives from an investee fund structured as a limited partnership (i.e., most domestic funds).
- **Private equity funds:** With respect to investments in private equity funds, management's reconciliation of the audited financial statement to the recorded investment balance may be more difficult because the economics of private equity funds may be unique. For instance, partnership agreements may require priority returns be made to limited partners before the general partner receives distributions of capital, after which the general partner may receive amounts in excess of its capital commitments (commonly known as carried interest). The investor entity's management must have a very good understanding of the partnership agreement and its effect on fair value as of the balance sheet date. The investor entity's analysis should generally incorporate a hypothetical liquidation approach (i.e., what amount would the investor entity be entitled to under the distribution terms of the investee fund agreement if the investee fund were to liquidate all of its investments at the balance sheet date). The investor entity must also be cognizant that some financial statements of private equity funds may not allocate unrealized gain/loss to the capital accounts of the limited partners. Lack of allocation of such amounts may result in large differences associated with capital balances for the partners. The investor entity must ensure that its analysis incorporates unrealized gain/loss amounts. Finally, it is always important for the auditor to read investor letters that accompany the annual financial statements because they may identify anticipated transactions or other information that may be relevant to the determination of fair value.

d. Review recent transactions

Under Statement of Auditing Standard No. 101, the auditor's substantive tests of fair value measurements involve examining subsequent events and transactions that confirm or disconfirm the estimate. The investor entity may liquidate a portion of its alternative investment as of a date close to the investor entity's fiscal year end to support the valuation of its investment. The auditor needs to consider how often these settlements occur and the procedures used to value them, including whether there are holdbacks or whether the transactions are between willing buyers and sellers.

Recent transactions not indicative of fair value

Sometimes a recent transaction should not be considered in the valuation considerations because it may not indicate fair value. Such an example often arises in the secondary private equity market where an investor purchases a limited partner's existing interest and remaining commitment in a private equity fund. This often results from the seller's need for liquidity, inability to fund future commitments or desire

to reduce exposure to private equity. The seller may sell its interest in a private equity fund to the buyer at a deep discount or at a premium to the fund's NAV. Consequently, the sale or transfer price between the buyer and the seller may not indicate a true fair value.

Another example is a "run on the fund," where funds have been forced to liquidate because of various circumstances, such as poor performance combined with expired lock-up periods or lack of "gates." This could become a situation of duress for the investee fund. In an effort to meet its redemption requests, the fund may be forced to liquidate securities in a "fire sale" situation. Such a forced liquidation or sale could result in values lower than those recorded on the books and records of the investee fund. Alternatively, the fund may sell its highly liquid investments first, leaving very illiquid investments in the portfolio. The auditor must consider those remaining investments if the investor entity remains in the fund. The investor entity must be aware of the activities occurring at the investee fund to ensure no circumstances can create a situation of duress that may affect the valuation of its investment. If indicators of duress arise, the investor entity requires additional effort to determine fair value.

Full and partial redemptions

On or close to the investor entity's fiscal year end, there may be full or partial redemptions of interests in investee funds. For a full redemption, as noted in Appendix B, the investee fund may hold back a portion of the investor entity's balance pending the issuance of the independent auditor's report of the investee fund. These amounts are generally recorded as receivables on the investor entity's books, and may range from 5 percent to 10 percent of the full redemption amount. After the auditor's report is released, the investee fund will then remit the remaining balance, with the ultimate balance perhaps being more or less than the balance recorded at year end. The investor entity's auditor's procedures should include vouching such amounts received and comparing adjustments to the amounts recorded at the balance sheet date.

Full redemptions can be indicative of value near the balance sheet date. For instance, close to year end, an investor entity may request a full redemption from an investee fund. The balance related to its investment may be materially consistent with the balance recorded at year end. Through its monitoring controls and other documentation, the investor entity should be able to assert the reasons for the difference between the year-end balance and the redemption amount. The combination of the cash received from the redemption and other documentation supporting the investor entity's assertion, with respect to the difference between the balance sheet value and redeemed value, may constitute sufficient audit evidence for the valuation assertion.

It is more difficult in a non-unitized fund environment (i.e., investment partnership) to gain significant comfort with respect to the valuation assertion from a partial redemption because there is no point of measurement for the investor entity. For example, if an investee fund reported an investor account balance of $5,000,000 and the investor entity requested $3,000,000 in redemption proceeds, the redemption provides less support for the valuation assertion with respect to the remaining $2,000,000. Accordingly, the auditor for the investor entity would have to gain additional audit evidence for both the existence and valuation assertions. With respect to unitized funds (i.e., most offshore funds), some audit comfort may be achieved because the number of units and dollar value per unit are known. But this depends on the circumstances associated with the transaction.

Summary of addressing the existence and valuation assertions

As discussed above, the auditor's approach is based on an assessment of the risk of material misstatement of the financial statements and must consider the quantity and quality of audit evidence to be obtained when assessing risks and designing further audit procedures.

Because alternative investments use varying structures and strategies, each with their own attributes and characteristics, they present unique audit risks. Accordingly, a "one-size-fits-all" approach to auditing an entity's interests in various alternative investments may not be appropriate or possible.

An effective and efficient process may involve the following:

1. Obtain management's risk assessment over its portfolio of alternative investments.
2. Review and assess such risk assessment and corroborate/test the information reflected.
3. Design efficient and effective procedures that address the unique risks associated with each investment, either individually or by assigned risk category, after considering all relevant factors.

Because of certain inherent issues associated with alternative investments, either individually or by assigned risk category, auditors may face challenges in obtaining the same quality and quantity of audit evidence across an investor entity's portfolio of alternative investments. The evaluation of the quality and quantity of audit evidence necessary to satisfy existence and valuation assertions is subject to the auditor's professional judgment.

Appendix A | Illustrative AU332 risk assessment and AU332 risk assessment considerations

The following illustrative AU332 risk assessment is provided as an example only. It depicts one approach management of investor entities might use to assess and summarize risk to determine the nature and extent of due diligence pursuant to the requirements of the AICPA Practice Aid. This example is not intended to be all-inclusive of every risk factor that management should consider.

	Risk rating[1]		
	Fund A	Fund B	Fund C
General information			
Fund type (e.g., hedge, private equity, real estate, fund-of-funds)			
Investment strategy			
Investor's original investment date			
Investor's investment balance at [date]			
Fund's net assets/partners' capital			
Amount			
As of date			
Fund manager's assets under management			
Amount			
As of date			
Fund's fiscal year end date			

1 Investor entities can use different approaches to assess the risk associated with their portfolio of alternative investments. Such approaches can be quantitatively driven based on the assignment of a risk score (i.e., 1 = lowest risk, 5 = highest risk) or more qualitatively driven.

Risk assessment areas[2]		Risk rating[1]		
		Fund A	Fund B	Fund C
	Management, governance and service providers			
	Quality and experience of fund management			
	Role and effectiveness of fund governance			
	Quality of service providers			
	Strategy, structure and key terms			
	Nature, complexity and liquidity of strategy			
	Nature of fund's liquidity terms			
	Complexity of structure and key terms			
	Transparency and reporting			
	Nature and quality of transparency			
	Quality of financial reporting			
	Internal controls			
	Adequacy of infrastructure, personnel and general internal controls			
	Design and effectiveness of valuation policies and procedures			
	Quality of risk monitoring			
	Impact of regulatory compliance matters			
	Impact of legal and tax matters			
	Other factors			
Composite Risk Rating/Score/Grade				

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

1 Investor entities can use different approaches to assess the risk associated with their portfolio of alternative investments. Such approaches can be quantitatively driven based on the assignment of a risk score (i.e., 1 = lowest risk, 5 = highest risk) or more qualitatively driven.

2 See accompanying pages for items to consider when assessing the risk associated with an investee fund.

AU332 risk assessment considerations

The following summarizes various considerations that management can use when addressing the risk areas in the AU332 risk assessment. These risk assessment considerations are for illustrative purposes only and are not intended to be all-inclusive of every risk factor that management should consider.

Management, governance and service providers

Quality and experience of fund management

- Is this a new or established investment manager?
- What is the quality and experience of management?
- Does the investment manager demonstrate that he or she is specifically qualified to execute the strategy in the market in which the investee fund invests?
- Is there evidence from similar endeavors of the ability of the principals to work together?

Role and effectiveness of fund governance

- Is there an Advisory Committee composed of certain limited partners or others? Is it effective?
- Is there a Board of Directors? If so, are there independent members? Is it effective?

Quality of service providers

- Are the auditors a reputable firm with the requisite knowledge and experience given the nature and complexity of the fund?
- Who is the prime broker? Will they use multiple prime brokers?
- Are the attorneys a well-established firm with appropriate industry experience?
- Is the administrator/accounting agent (if outsourced) experienced and well-established?

Strategy, structure and key terms

Nature, complexity and liquidity of strategy

- What is the nature, complexity and liquidity of the investment portfolio?
- Consider the following:
  - Investment strategy
  - Performance history
  - Concentrations and exposures
  - Asset classes (e.g., equities, fixed income, derivatives, private equity)
  - Volatility
  - Volume of transactions
  - Leverage and use of derivatives
- What is the risk and complexity of the financial instruments in the portfolio?
- Consider the following:
  - Market prices are readily available from active markets with significant transparency and reliability (e.g., stocks, bonds, options, futures).
  - Prices can be obtained from multiple sources such as dealers, brokers and intermediaries based on active markets with reasonable transparency, reliability and objectivity (e.g., certain high-yield bonds, forward contracts, matrix pricing of municipal bonds).
  - Prices can be obtained but the prices are not completely transparent, and the quality and reliability vary. The information is generally obtainable from dealers, although there may be wide spreads in prices (e.g., asset-backed securities, mortgage-backed securities, CDOs).
  - Prices are not observable in the market but can be derived from observable market data or estimated from historical performance or comparable data. The derivation or estimation requires a level of judgment (e.g., structured products, private equity).

Nature of fund's liquidity terms

- What is the liquidity of the investee fund?
- Consider the following:
  - Subscription frequency (e.g., monthly, quarterly, annually, commitments)
  - Redemption frequency (e.g., monthly, quarterly, annually, closed end)
    - Gates
    - Early redemption charges
    - Side pockets
    - Holdbacks
    - Lock-ups
- To what extent is the liquidity of the investee fund's portfolio consistent with the liquidity provisions of the investee fund itself?

Complexity of structure and key terms

- What is the complexity of the investee fund structure and key terms?
- Consider the following:
  - Management fee
  - Incentive fee/allocations
  - Carried interest
  - Hurdle rate/preferred return
  - High-water mark
  - Clawback provisions
  - Loss carryforward
  - Master-feeder
  - Multi-tiered
  - Side-by-side
  - Fund-of-funds
  - Side letters
  - Special-purpose vehicles
  - Opt-out provisions

Transparency and reporting

Nature and quality of transparency

- What is the nature, extent and timeliness of the investee fund manager's reporting (e.g., monthly, quarterly, annual statements; written correspondence in the form of newsletters, discussion of holdings and performance)?
- What level and quality of transparency is provided by the investee fund manager (e.g., full access to portfolio positions, access to books and records, access to portfolio managers and key accounting and operational personnel)?

Quality of financial reporting

- Are the accounting policies and procedures consistent with industry practice? Under what basis of accounting are the financial statements of the investee fund prepared (e.g., US GAAP, International Financial Reporting Standards, Tax)? Is it the same basis as the investor entity?
- Is the investee fund's year end coterminous with the investor entity's reporting year end?
- Has the investee fund received anything other than an unqualified audit opinion in the past three years?
- Do the financial statements contain a portfolio of investments? Is it condensed or detailed? Does it contain enough information to assess geographical or industry concentrations?
- Are there unusual accounting policies or disclosures, including related-party disclosures?

Internal controls

Adequacy of infrastructure, personnel and general internal controls

- What is the quality of the fund accounting and operational personnel? Does the investee fund manager have a sufficient complement of accounting and finance personnel with the requisite skills, experience and training to provide for the investee fund's needs?
- What is the financial condition of the investment management firm?
- Is there a good relationship between management, the board of directors and the investors?
- Are there written policies and procedures commensurate with the size, nature and complexity of the funds trading strategies? If yes, how frequently are such policies reviewed and approved by senior management?
- Does the investment manager have the necessary infrastructure to execute, process and account for the transactions?
- Does the fund manager maintain adequate oversight over outside service providers such as prime brokers, custodians, administrators, investment consultants, sub-advisors, etc.? Are such firms reputable and experienced?
- Is the fund's strategy a core or ancillary strategy of the manager? Is this a new strategy?
- Are all trading strategies determined, approved and reviewed by senior management?
- Is there a SAS 70 or other attest engagement performed over the control environment by external auditors? If service providers are used (e.g., fund administrator), is there a SAS 70 over their control environment? If applicable, what is the nature of the SAS 70 report?
- Is there an internal audit function within the complex and, if so, does that internal audit department include the investee fund operations within the scope of its review each year?

Design and effectiveness of valuation policies and procedures

- Does the firm have comprehensive written valuation policies and procedures that address the key methodologies and related inputs, by asset class, and the roles and responsibilities of the key parties in the valuation process?
- What is the degree of independence in the valuation process?
  - Role of front office
  - Role of back office
  - Role of service providers (e.g., third-party valuation experts)
  - Role of Valuation Committee
- Does a Valuation Committee exist and is it effective? Does it consist of any independent members?
- If valuation models are utilized, are:
  - They standard?
  - They consistently applied?
  - The key assumptions reasonable and reliable?
  - Third-party experts involved?
- Are there adequate information technology controls, including a disaster recovery plan?

Quality of risk monitoring

- Are there risk limitation policies?
- What types of monitoring, reporting, escalation and resolution processes exist?
- Are "stress tests" performed on a regular basis?
- Are the concentrations of risk in the portfolio routinely measured against the trading covenants/restrictions outlined in the fund's governing documents (asset class, industry, geography, etc.)?
- What is the nature of the policies and procedures around the cash management function?
- What are the sources of liquidity available to the fund?
- What policies and procedures exist around measuring the fund's exposure to potential defaults by the fund's counterparties?
- Do policies and procedures exist to measure the fund's exposure to leverage? Are they operating as prescribed?
- What policies and procedures exist to measure the fund's exposure to operational risk (data entry errors, system failures, valuation errors, fraud)?

Impact of regulatory compliance matters

- Is the advisor or the investee fund subject to SEC, CFTC, DOL, FSA or other regulations?
- If so, have there been any examinations by the regulatory bodies?
- What were the results?
    - Any investigations, sanctions or enforcement proceedings?
    - Any threatened or pending litigation?
- Does the investee fund manager maintain procedures for tracking and meeting large position reporting requirements?
- Is the investee fund manager's compliance with regulatory requirements independently reviewed? How often?
- Is there an effective chief compliance officer? Have his/her reviews resulted in any material findings that would affect the investee fund?
- Has senior management instituted a training program for all employees with respect to ethics and compliance procedures?
- Does management of the investee fund have a robust anti-money laundering program in place?

Impact of legal and tax matters

- Does the complex have an effective in-house legal function that is recognized as part of senior management?
- Are all agreements with all relevant counterparties formally documented with legally binding agreements?
- Has management established formal, written document retention policies?
- Are there any lawsuits or litigation involving the general partner, its principals, employees or prior funds that would impact the investment manager or the fund?
- Are there any conflicts of interest with regard to the investee fund, as well as activities of the principals?
- Has the fund broken any covenants relating to any credit facilities or other counterparty arrangements? If yes, has the fund obtained appropriate waivers from the counterparty/credit provider?
- Is there an effective tax function and related internal controls?
- Are there significant uncertain tax positions?

Appendix B | Liquidity terms

Lock-up Period

A lock-up period refers to the initial amount of time a limited partner or shareholder is required to keep his or her money in a hedge fund before redeeming it. When the lock-up period is over, the limited partner or shareholder is free to redeem his or her interests in the fund on any liquidity date, subject to the other liquidity terms described in the fund documents. Whether a hedge fund demands a long lock-up period depends a great deal on the quality and reputation of the hedge fund as well as the liquidity of the underlying investment portfolio. Investors may be able to redeem during a lock-up period after they pay a “redemption fee,” often 3 percent to 5 percent of the amount requested to be redeemed.

Notice Requirement

Following the expiration of any applicable lock-up period, a limited partner or shareholder may, upon specified prior written notice (generally 45 days to 120 days) to the general partner or manager (a “Redemption Notice”), elect to redeem all or a portion of his or her interest in a hedge fund as of the last day of a calendar quarter or month (the “Redemption Date”). Redemption requests are generally irrevocable once delivered and are unconditional. Redemption requests that purport to be revocable or conditional can generally be ignored or treated as irrevocable and unconditional, at the discretion of the general partner or investment manager.

Payment and Holdback

When the general partner or investment manager receives a Redemption Notice, the hedge fund will redeem the interests of a limited partner or shareholder as specified in the Redemption Notice, at the redemption price as of the applicable Redemption Date. The fund will distribute all or a substantial portion (i.e., 90 percent) of the redemption price with respect to the interests being redeemed within a specified number of business days (e.g., 30) following the applicable Redemption Date. Any balance (i.e., the remaining 10 percent) is distributed within a specific timeframe, often following the release of the fund’s audited financial statements for the year in which the Redemption Date falls. Sometimes (but not always) the redeeming limited partner or shareholder is entitled to interest on the unremitted balance. Holdback amounts protect the general partner or investment manager from adjustments made to the net asset value of the fund as a result of an audit of the financial statements.

Side Pockets

Some hedge funds have an investment strategy that allows the fund to invest in illiquid securities, yet investors are still allowed periodic redemption. In such cases, a common mechanism used is a "side pocket," whereby, at the time an investment is made in such an illiquid security, a proportionate share of a limited partner's capital account, relative to the entire capital balance of the fund, is assigned to a separate memorandum capital account or "side pocket account" for that limited partner. This side pocket account generally does not incur a performance fee until the illiquid security is sold or otherwise deemed liquid. Typically, limited partners lose redemption rights to their side pocket accounts, and even a full redemption request is fulfilled only with that capital ascribed to his or her "basic" capital account (i.e., the non-side pocket capital account). Only after the security is sold (or otherwise deemed liquid) by the fund is the amount moved back to each applicable limited partner's basic capital account. Side pocket accounts are often referred to as "designated accounts" or as "special investment accounts."

Suspension or Postponement of Redemption

Pursuant to the hedge fund's governing documents, the general partner or investment manager can suspend or restrict the determination of net asset value and/or the right of any limited partner or shareholder to redeem his or her interests (whether in whole or in part). The general partner or investment manager can implement this restriction for certain reasons, including the aggregate amount of redemption requests, certain adverse regulatory and tax consequences and other reasons that may cause the inability to promptly and accurately calculate the fund's net asset value. The most common example is the use of a "gate," whereby redemption requests are deferred because the aggregate amount of redemption requests as of a particular Redemption Date exceeds a specified level, generally ranging from 15 percent to 25 percent of the fund's net asset value.

Appendix C | Other key terms

Hedge funds

Key terms / Potential implications

Classes of Shares or Partnership Interests

Offshore hedge funds may issue interests in the form of a single class of shares or multiple classes of shares. Partnerships may also have different ownership classes or interests. Multiple-class funds have unique operational and accounting issues. The terms of the fund documents dictate how income, expenses, gains and losses are to be allocated to determine the net asset value for each class or interest. In addition, specific classes may have class-specific expenses or be entitled to specific items of income (e.g., "new issue" income). Finally, fee waivers may exist for certain classes of shares.

The investor entity should understand the terms of its ownership interest and ensure that the class of shares or partnership interest that is reported by the investee fund manager on its investor statement is consistent with the subscription documents maintained in its files.

High-Water Mark

A high-water mark ensures that an incentive fee/allocation (see below) is made only to the extent that the net asset value of an investor's interest exceeds the highest net asset value as of any previous incentive fee/allocation period. In general, a high-water mark is the capital balance of an individual partner/shareholder after the last incentive fee/allocation was charged. This balance is then adjusted for any contributions or withdrawals during the period to establish a new high-water mark. The agreement or offering memorandum defines the high-water mark and dictates how the incentive fee/allocation is calculated.

The investor entity should be aware of the high-water mark provision in the fund documents and if its investment exceeds the high-water mark for a given period. If the investment balance exceeds the high-water mark, the investor entity should ensure that its net asset value is calculated net of the incentive fee/allocation.

Incentive Fee/Allocation

Incentive fee/allocation is performance-based compensation in which the investment manager or general partner receives a specified percentage (often 20 percent) of net income. These amounts are accounted for in accordance with the offering memorandum/partnership agreement, sometimes as an expense (income statement) as in the case of a corporate structure or as a special allocation of partnership profits (statement of changes in partners' capital) to the general partner in the case of a partnership. The amount of the allocation should be shown in the statement of operations or in the statement of changes in partners' capital, and the method of computing such allocations should be disclosed.

When determining fair value, the investor entity should ensure that its capital balance is reported net of the incentive fee/allocation.

Key terms	Potential implications

Loss Carryforward

A loss carryforward is a technique or provision in the partnership agreement or offering document that applies the current year's net operating losses to future period profits when calculating the incentive fee/allocations. These provisions protect the investor entity by ensuring the general partner or investment manager makes up the shortfall of losses before he or she is entitled to any incentive fee based on profits. Accordingly, if the investee fund has earned profits in the current period, the general partner or investment manager may not be entitled to an incentive fee/allocation because there may be pre-existing loss carryforwards from prior periods. Typically, unused carryforwards are reduced pro rata for redemptions made while they are outstanding.

The investor entity must be aware of loss carryforward provisions that exist in investee fund partnership agreements and the impact, if any, to the fair value of its investment.

Master-Feeder Funds

Certain funds will have structures under which they invest in other affiliated funds. A feeder fund is a fund that conducts virtually all of its investing through another fund (called the master fund). The master fund conducts all investing activities. Each feeder fund's statement of assets and liabilities shows an investment in the master fund, which is usually the sole or principal investment of the feeder fund.

A schedule of portfolio investments is generally not presented at the feeder level. Accordingly, the investor entity should obtain the feeder fund's and the master fund's financial statements to ascertain the capital structure and associated net asset value of its investment and understand the nature, complexity and liquidity of the underlying portfolio investments.

New Issue Eligibility

New issue securities are defined by the National Association of Securities Dealers Inc. (NASD) as equity securities being sold through an initial public offering. Resulting profits or losses from new issue securities are not allocated to the capital accounts of those investor entities considered to be restricted persons. In many cases, separate share classes will be created for shareholders who are eligible and ineligible to participate in new issue income.

The investor entity should be aware of its eligibility and whether it has subscribed to the appropriate class of shares. Accordingly, when analyzing the fair value of its investment, the investor entity should ensure that new issue income has been properly included or excluded from its capital account balance.

Key terms	Potential implications
Open-End Fund	
An open-end fund is an investment company that is ready to offer or redeem its shares or partnership interests periodically. Open-end funds provide for liquidity to investor entities. The frequency of contributions or redemptions is dictated by the fund's documents. Contributions and redemptions can be monthly, quarterly, semi-annually, annually, etc. The amount of liquidity provided to investor entities in a particular fund is usually consistent with the liquidity and risk associated with the underlying portfolio (i.e., the more liquid the investments in the portfolio, the greater the liquidity generally provided to the investors).	The investor entity should be aware of the liquidity provisions associated with the fund in which it invests. If the investee fund is less liquid, the investor should have a better understanding of the nature, complexity and risks associated with the underlying investments.
Side Letters	
In general, a side letter is a private agreement between a general partner and a limited partner, relating to the limited partner's investment in a partnership, which provides the limited partner with rights that are not otherwise available to the limited partners under the fund agreements. A side letter typically appears as a unilateral letter agreement delivered by the general partner to the limited partner, although it can be drafted as a traditional, two-party agreement. Side letters may provide for certain agreements outside of the partnership agreement, such as management fee waivers, co-invest or opt-out provisions.	Side letters are not part of the fund agreements; therefore, those within the investor entity responsible for monitoring of and accounting for the investment must know if side letters exist between the investor entity and the fund because the side letter may have a direct impact on the calculation of the investor entity's investment in the investee fund.
Special-Purpose Vehicle (SPV)	
Special-purpose vehicles (SPV) are usually created for a single, well-defined and narrow purpose. The SPV can take any number of legal forms: corporation, partnership, trust, unincorporated entity or a multi-user structure (such as a protected cell company). In certain cases, SPVs are referred to as a "bankruptcy-remote entity," with operations limited to the acquisition and financing of specific assets. Sometimes, funds will own interests in SPVs, which will in turn own interests in specific investments.	Just as the investor entity must understand the terms and conditions associated with an investee fund, it must also understand the terms and conditions associated with the SPV and its effect on the liquidity and fair value of the investee fund.

Private equity funds

Key terms	Potential implications

Capital Commitments

A capital commitment is a general or limited partner's obligation to provide a certain amount of capital to a fund. Commitments are usually made up front at the time capital is raised. Profits and losses may be allocated in accordance with capital commitments or unfunded capital commitments rather than capital contributed to the fund.

The investor entity should consider its ability to meet its obligations under its capital commitment. Disclosure should be made in the financial statements with respect to the investor entity's obligation.

Carried Interest

This term denotes the split of profits to the general partner. This is the general partner's compensation for carrying the management responsibility plus all the liability for serving as general partner, as well as providing the needed expertise to successfully manage the investments in the fund. Carried interest is somewhat analogous to incentive fee/allocation for a hedge fund. There are many variations of this profit split, both in its size and how it is calculated and accrued. The carried interest terms will affect the balance of the capital account for both the general partner and limited partners, depending on the terms of the agreement.

Carried interest incorporates a "waterfall" calculation based on the terms of the agreement. The investor entity should be aware that in certain cases the carried interest is considered more of a distribution concept than an allocation concept. The investor entity must ensure that the investee fund considered a hypothetical liquidation model when calculating its capital account (i.e., if the fund were completely liquidated on the reporting date, how would the proceeds be distributed to the general partner and the limited partners?). In most cases, but not all, this allocation is reflected in the capital statement already – on a hypothetical liquidation basis – and disclosed as such.

Clawback

A clawback obligation represents the general partner's promise that, over the life of the fund, the managers will not receive a greater share of the fund's distributions than they are entitled to. Generally, this means that the general partner cannot keep distributions representing more than a specified percentage (e.g., 20 percent) of the fund's cumulative profits. When triggered, the clawback requires that the general partner return to the fund an amount equal to what is determined to be "excess" distributions. Clawbacks can present issues with respect to valuation when the value of the portfolio falls below a specific threshold. Issues arise because carried interest distributions have often already been made to the general partner, thus requiring that amounts be returned to the fund by the general partner. The calculation of the amount of clawback obligation is dictated by a number of technical, often highly negotiated, provisions in the fund's limited partnership agreement. These provisions look at the aggregate amount of distributions received by the general partner over the life of the fund, but typically exclude both amounts received in respect of the general partner's capital contribution (usually 1 percent) and the taxes payable by the general partner on all carried interest distributions. More complex provisions exist as well. When applying the waterfall calculation concept, clawback provisions must be taken into consideration. Also see *Carried Interest* above.

When a clawback is triggered, it may affect the investor entity's interest in the investee fund. Certain clawback provisions may result in a negative general partner balance or a receivable from the general partner. The investor entity must assess the impact of the clawback on its own investment balance and consider the credit risk associated with the general partner's obligation to refund the clawback to the partnership. Also see *Carried Interest* above.

Key terms	Potential implications

Closed-End Fund

A closed-end fund is an investment company that has a fixed number of shares outstanding or a fixed amount of capital commitments from investors, which it does not stand ready to redeem. This structure is very common to private equity funds because the underlying investments are illiquid. As such, the fund has no liquidity to provide for redemptions to investors. Accordingly, investors are "locked in" and must wait until the fund can sell its investments in order to convert the fair value of the investment into cash that can then be distributed under the terms of the agreement.

The investor entity should be aware of the liquidity provisions associated with the fund in which it invests. If the investee fund is less liquid, the investor entity should have a better understanding of the nature, complexity and risks associated with the underlying investment portfolio.

In-Kind Contributions and Distributions

Certain agreements may provide for capital contributions or distributions in the form of securities or investments in other funds. The valuation of these transactions, for purposes of allocations/distributions under the agreement, may be non-GAAP. For instance, for a private equity fund, a distribution may be based on a value determined using a 10-day average, unlike GAAP, which would require the securities to be fair valued on the date of distribution.

The investor entity should be aware of the accounting policies used by the investee fund and ensure that its accounting policy conforms with GAAP.

Opt-out Provisions

Certain investment partnership agreements will allow partners to "opt out" of a particular investment by providing a written notice or written opinion to the effect that a limited partner's participation in such investment would have a detrimental effect due to legal, regulatory, or other requirements. Accordingly, the limited partner would be excluded from participation in that type of investment within the fund's portfolio.

Gains and losses associated from the restricted investment should not be reflected as part of the fair value of the investor entity's interest in the investee fund.

Key terms	Potential implications
Preferred Return and Catch-Up Amount The preferred return is the internal rate of return that a fund must achieve before its general partner can receive a carried interest. When the fund achieves the preferred return as defined in the fund documents, the general partner is usually entitled to receive a carried interest (see definition above). In many cases, the general partner is entitled to a "catch-up amount" whereby all or a specified large percentage of profit is allocated to the general partner after the preferred return is achieved until the general partner has received cumulative profits equal to the carried interest percentage (e.g., 20 percent).	See *Carried Interest* discussed earlier.
Priority Allocation Certain funds may incorporate priority returns to the general partner or other partner that result in economics for a partner or shareholder that are other than a pro rata share of income or loss. For example, this could take the form of management fees waived by the general partner in exchange for a priority allocation of a gain associated with a particular investment.	Priority allocations must be taken into consideration when applying the waterfall provisions of a private equity partnership agreement in determining the fair value of an interest in that partnership.

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